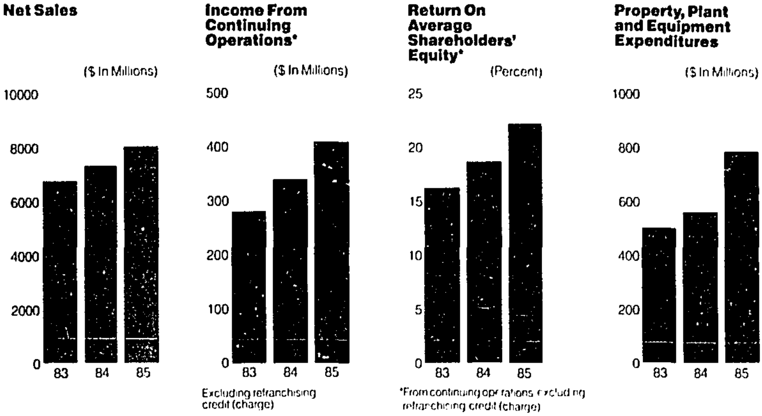
PepsiCo, Inc. 1985

20 YEARS OF
- **Innovative Products**
- **Rapidly Expanding Markets**
- **Vigorous Growth**

Financial Summary



($ in millions except per share amounts)		1985	1984	Percent Change
Net Sales	$	**8,056.7**	7,451.1	**+8**
Income from continuing operations before refranchising credit (charge)	$	**405.2**	337.0	**+20**
Per share	$	**4.35**	3.55	**+23**
Refranchising credit (charge)	$	**14.9**	(62.0)	**–**
Per share	$	**.16**	(.65)	**–**
Income from continuing operations	$	**420.1**	275.0	**+53**
Per share	$	**4.51**	2.90	**+56**
Income (loss) from discontinued operations	$	**123.6**	(62.5)	**–**
Per share	$	**1.32**	(.65)	**–**
Net income	$	**543.7**	212.5	**+156**
Per share	$	**5.83**	2.25	**+159**
Dividends declared	$	**161.2**	156.2	**+3**
Per share	$	**1.76**	1.67	**+5**
Return on average shareholders' equity	%	**22.0**	18.5	**+19**
Property, plant and equipment expenditures	$	**785.9**	555.8	**+41**

The refranchising credit (charge) relates to the refranchising of several company owned foreign bottling operations. See Notes to Consolidated Financial Statements on page 43 for more detailed information.

Discontinued operations include the gain or loss on the sale of North American Van Lines, Wilson Sporting Goods and Lee Way Motor Freight and their results of operations through the date of their respective sales. See Notes to Consolidated Financial Statements on page 44 for more detailed information.

The return on average shareholders' equity is calculated using income from continuing operations before refranchising credit (charge).

Contents

To Our Shareholders

In 1965 Pepsi-Cola and Frito-Lay merged to form PepsiCo. Our objective was to build one of the premier consumer products companies in the world. By any measure, we believe we've succeeded.

Twenty exciting years have passed, and today PepsiCo is in an era of sustained high growth. Strategic reshaping has made our company leaner, more tightly focused and an even more effective competitor.

- We have leadership positions in three very attractive consumer businesses–soft drinks, snack foods and restaurants. Each is very large and very responsive to product, packaging and marketing innovations. As a result, these markets have been growing rapidly and show every sign of continued growth in the future.
- We have the strong brand names, advertising impact and marketing savvy necessary to achieve outstanding results.
- We have the innovative management talent required to outmaneuver our competition.
- And we have the financial strength and flexibility to maintain our impressive momentum.

Although our company is large and complex–with 150,000 employees doing business in more than 120 countries–our management philosophy is quite simple. Our priority is to maximize shareholder value, primarily through internal growth and astute application of our financial resources.

Business Investment

To illustrate our commitment to internal growth, last year we invested $786 million in our existing businesses. We significantly expanded our soft drink operations, added more units to our restaurant system than ever before and built a state-of-the-art snack food manufacturing plant to expand Frito-Lay's markets. In 1986 we plan even higher capital spending to support our aggressive growth objectives.

We also used our financial resources in 1985 to spend $458 million repurchasing more than seven percent of our outstanding common stock. This investment, coupled with the continued growth and vitality of all our businesses, produced earnings per share gains of 23 percent and drove our return on equity to an all-time high of 22 percent. Income of $405 million rose 20 percent, and sales of $8.1 billion increased eight percent. PepsiCo stock outperformed a very strong market; the price of our shares soared 70 percent.

Growth Opportunities

We also took advantage of attractive acquisition opportunities. We purchased for $160 million Allegheny Pepsi-Cola Bottling Company, one of our more important bottlers, and signed agreements for two other key acquisitions. During 1986 we'll complete the $590 million purchase of MEI Corporation, one of the largest and most profitable Pepsi-Cola bottlers. We also intend to purchase for $380 million the worldwide franchise beverage operations of The Seven-Up Company. 7UP is one of the most valuable trademarks in the world. And, based on our success with Pepsi-Cola products, we believe we can significantly build the 7UP brand and strengthen its bottler network.

These acquisitions, which will add nearly $1 billion to our soft drink sales, reflect our continued belief that the greatest growth opportunities lie in our existing businesses. Building on our strengths makes good economic and marketing sense, and is one of the most effective ways to increase shareholder value.

Complementing this commitment to existing lines of business, we'll continue to be alert to growth opportunities in related markets.

Board of Directors

The overall guidance of our company remains in the strong hands of our Board of Directors, which includes some of the most distinguished leaders in the fields of business, law, finance and education.

And we're very pleased to welcome to our Board Sharon Percy Rockefeller. She has demonstrated considerable leadership on the Corporation for Public Broadcasting, including service as its chairman. Mrs. Rockefeller also has been very active in a wide range of political, social and educational programs, and brings valuable insights to our Board.

On a sad note, we mourn the death of Harold R. Lilley, one of the early leaders of our corporation. Mr. Lilley was associated with Frito-Lay for 22 years, and served on our Board for nine years until his retirement in 1978. Harold Lilley was a friend and an able businessman who made major contributions to the success we enjoy today.

Continuing Commitment

The goals we established for ourselves in 1965 have been refined, but never altered. Our success over the past 20 years reflects our continuing commitment to growth and our resolve to focus on those businesses where we can drive that growth ourselves and create our own opportunities.

In the pages that follow, we report on some of the highlights of our dramatic growth. And, more importantly, we discuss the characteristics that shaped our success in the past, that were responsible for our record performance in 1985 and that will guide our continuing growth in the years ahead.

February 27, 1986

Donald M Kendall

Donald M. Kendall
Chairman of the Board and
Chief Executive Officer

Wayne Calloway

D. Wayne Calloway
President and
Chief Operating Officer

Seated, Donald M. Kendall, chairman of the board and chief executive officer. Standing, Michael H. Jordan, (left) executive vice president and chief financial officer, and D. Wayne Calloway, president and chief operating officer.

PepsiCo, 1965-1985: A Distinguished Record of Growth and Achievement

In 1965 two well-known consumer product companies joined forces in what today is regarded as one of the most successful mergers in the history of American business The formation of PepsiCo, Inc was engineered by Donald M Kendall (right), president and chief executive officer of Pepsi-Cola, and the late Herman W Lay, chairman and chief executive officer of Frito-Lay

Both companies embodied very similar characteristics in two related markets soft drinks and snack foods

Both had strong positions in very large consumer markets, with major brands promoted by extensive advertising And both relied on broadly based, efficient manufacturing and distribution systems

Don Kendall and Herman Lay recognized that the marketing skills and operational talents in their respective companies were complementary and transferable It was one of the first and best examples of true synergy.

Although the two organizations have maintained their autonomy throughout the past 20 years, their goals, objectives and management philosophy have remained the same

Consequently, our management talent has moved easily from one division to another This cross-divisional movement has been an excellent developmental tool, and continually provides both relevant experience and fresh perspectives to managers in each of our businesses.

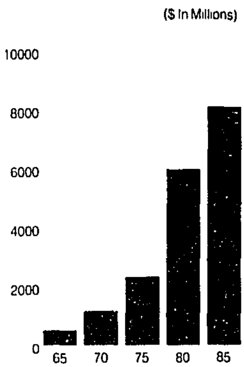
We also established a third strategic leg for our company—restaurants—with the acquisitions of Pizza Hut in 1977 and Taco Bell in 1978 Here, again, the dominant characteristics of this new business mirrored the critical factors in soft drinks and snack foods: major brand names in large expandable markets, a strong marketing focus and the competitive advantages offered by large-scale operating systems

Growth in all three businesses also has been driven by the development of key markets outside the United States PepsiCo has expanded its reach to more than 120 countries around the globe One of the most dramatic examples was the historic introduction of Pepsi-Cola to the Soviet people in 1959 at the American National Exhibition in Moscow, which led to the growth of an enormous Pepsi-Cola business throughout Eastern Europe Today there are 16 Pepsi-Cola plants in the Soviet Union alone And, looking ahead, the international marketplace offers some of the best opportunities for PepsiCo's continuing growth

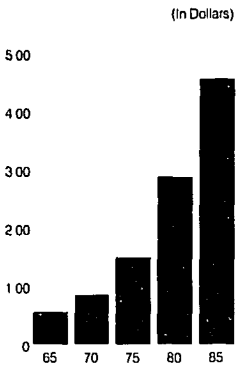
Today, the company is well-positioned to take full advantage of opportunities both overseas and in the United States

The following pages depict some of the highlights of the past two decades that have led the business press to label our company a "dominant power in beverages, snacks and fast foods" led by "a fast-moving, risk-oriented management with an exquisite sense of timing."

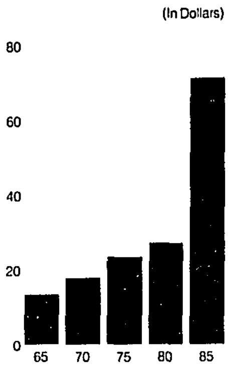
Net Sales



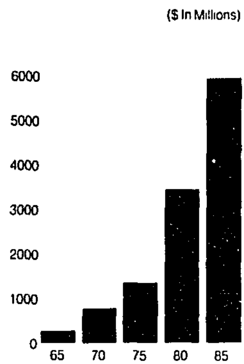
Earnings Per Share



Stock Price



Total Assets

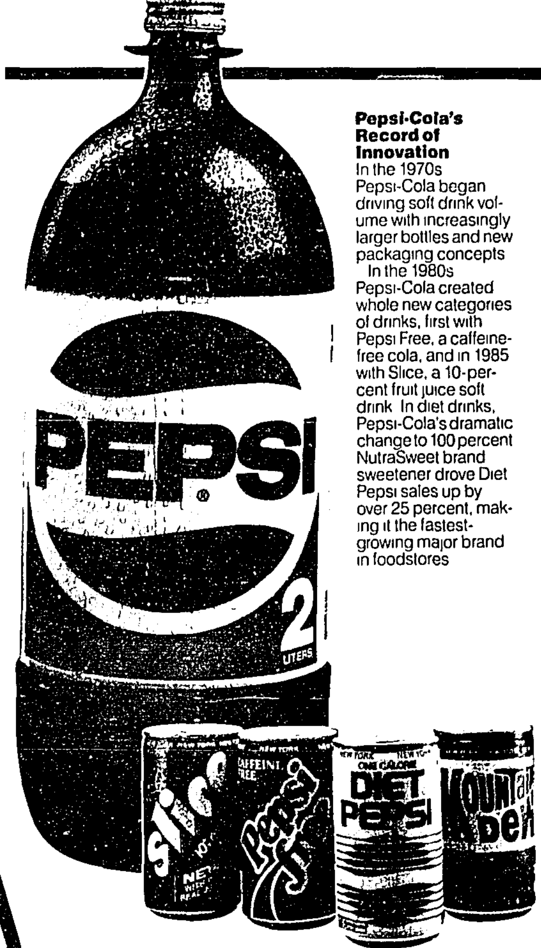


International Expansion
PepsiCo's dramatic growth story has spanned the globe. In 1974 Pepsi-Cola became the first American consumer product sold in the Soviet Union. On that occasion, Don Kendall presented Soviet General Secretary Leonid Brezhnev with the first bottle of Pepsi produced in the USSR. In 1980 Egyptian President Anwar el-Sadat and Kendall dedicated a new Pepsi-Cola bottling plant and announced that Pepsi-Cola would help Egypt in an agricultural project. Most recently, in early 1986, Kendall met with Chinese Premier Zhao Ziyang following the opening of the second Pepsi-Cola bottling plant in the People's Republic of China.

The Pepsi Generation— Still Going Strong!
The Pepsi Generation campaign has produced memorable and award-winning commercials that have tugged at the heart, grabbed headlines and made brand Pepsi the leading U.S. soft drink in foodstores.

Themes included "Come Alive! You're in the Pepsi Generation!" "Taste that beats the others cold. Pepsi pours it on." "Have a Pepsi Day." "Pepsi Now!" And of course there were the Michael Jackson and Lionel Richie blockbusters.

Frito-Lay's Crisp and Crunchy Advertising
In 1965 the Bert Lahr campaign, "Betcha can't eat just one," marked the beginning of a string of memorable campaigns that included W.C. Fritos, the Chee·tos mouse, Avery Schreiber's "crunch" campaign and Herman Lay talking about the "great potatoes" that go into the production of Lay's brand chips. In 1985 Tostitos brand tortilla chips advertising captured both critical acclaim and strong viewer recognition with memorable characters from the past: Beaver Cleaver, Mr. Ed and Sergeant Joe Friday.



Pepsi-Cola's Record of Innovation

In the 1970s Pepsi-Cola began driving soft drink volume with increasingly larger bottles and new packaging concepts. In the 1980s Pepsi-Cola created whole new categories of drinks, first with Pepsi Free, a caffeine-free cola, and in 1985 with Slice, a 10-percent fruit juice soft drink. In diet drinks, Pepsi-Cola's dramatic change to 100 percent NutraSweet brand sweetener drove Diet Pepsi sales up by over 25 percent, making it the fastest-growing major brand in foodstores.

Pizza Hut's Dramatic Growth

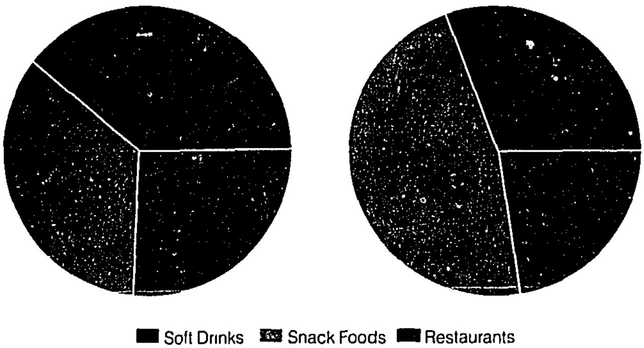
At the time Pizza Hut was acquired in 1977, there were 2,600 of the familiar red-roofed restaurants. In just eight years nearly 2,000 more were added. Pan Pizza, introduced in 1980 marked the beginning of a new era of growth. In 1983 Personal Pan Pizza once again boosted average store sales.

Taco Bell: Into the Mainstream

When PepsiCo acquired Taco Bell in 1978, there were fewer than 900 restaurants. By year-end 1985 nearly 2,200 were operating. In addition to an aggressive building program, average store sales were improved by the addition of drive-thru windows. In 1985 innovative products and entirely new decor brought Taco Bell further into the mainstream of fast service restaurant choices.

PepsiCo Today: Three Major Businesses

Net Sales (1985) — Operating Profits (1985)



($ in Millions)

Net Sales

	1985		1984		1983	
Soft Drinks	**$3,128.5**	**39%**	$2,908.4	39%	$2,940.4	43%
Snack Foods	**2,847.1**	**35**	2,709.2	36	2,430.1	35
Restaurants	**2,081.1**	**26**	1,833.5	25	1,529.4	22
Total	**$8,056.7**	**100%**	$7,451.1	100%	$6,899.9	100%

Operating Profits*

	1985		1984		1983	
Soft Drinks	**$ 263.9**	**31%**	$ 246.4	30%	$ 126.2	20%
Snack Foods	**401.0**	**47**	393.9	48	347.7	55
Restaurants	**194.0**	**22**	175.2	22	154.3	25
Total	**$ 858.9**	**100%**	$ 815.5	100%	$ 628.2	100%

* Soft drinks amounts in 1985 and 1984 exclude refranchising credit (charge) See page 43

For 20 years—driving growth in distinctive ways

Since PepsiCo's formation in 1965, we've demonstrated a remarkable ability to drive our own growth. Five distinctive characteristics have shaped our company over the past 20 years and remain responsible for our continuing growth:

1. ***Leadership in large, elastic, rapidly expanding businesses (page 10),***
2. ***Building the business with both new products and established brands (page 12),***
3. ***Complex, efficient operating systems that provide distinct competitive advantages (page 16),***
4. ***Major brand names with huge consumer equity, aggressively marketed (page 18),***
5. ***Financial strength and flexibility (page 20).***

Through these distinctive characteristics, described in the following section, we'll continue to build shareholder value in the years ahead.

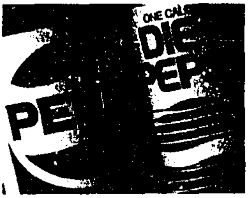
1

For 20 years we've driven our growth through...

Leadership positions in big markets

We operate only in very large, highly elastic and rapidly growing businesses where we use strength and innovation to create growth and opportunity.

SOFT DRINKS



PepsiCo earns about one-third of its operating profits through a leading position in the $39 billion U S soft drink industry Since 1965 the industry has more than tripled, and Pepsi-Cola has been responsible for much of this growth

Over the last five years, soft drink industry sales have been growing at a compound annual rate of nine percent.

Pepsi-Cola USA sales have been growing much faster–17 percent–while operating profits have risen at nearly a 10 percent rate

Today, soft drinks is the largest-selling category in supermarkets And almost one of every three soft drinks sold in foodstores is a Pepsi-Cola product In 1985 Pepsi-Cola's share increase in foodstores was more than twice that of its closest competitor.

The outlook for the soft drink industry continues to be bright. Importantly, every age group of the population is increasing its consumption of soft drinks–including older age groups interested in diet, caffeine-free and juice-based soft drinks

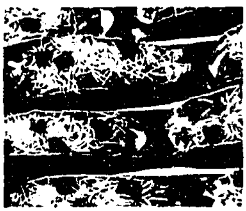
SNACK FOODS

PepsiCo today derives nearly half its operating profits from the domestic snack food market–a $20 billion industry Salty snacks –with $6 billion in annual sales–are a major portion of this market, and Frito-Lay is the major force in this segment. In 1965 Frito-Lay became the first nationwide snack food company Today no competitor can match its range of snack food products or the reach of its distribution network.

Sales in the salty snack market have been growing at a compound rate of 11 percent for the last five years Frito-Lay has accounted for much of this growth, while increasing profits 12 percent annually.

Twenty years ago salty snacks were less than a $600 million market But, as meals become more casual, people are consuming more snacks in a wider variety Frito-Lay, with its leadership role in salty snacks, is in an excellent position to expand in the larger snack food market.

RESTAURANTS



Restaurants–PepsiCo's newest business–account for about a quarter of our operating profits, and are our fastest-growing business

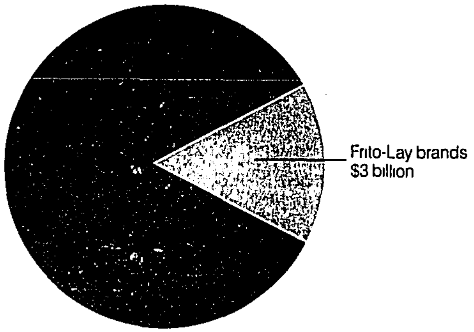
Pizza and Mexican food are among the largest-selling and the fastest-growing restaurant segments The annual growth rate for the $10 billion pizza category is 14 percent; for the $1 4 billion Mexican category, it is nearly 14 percent

PepsiCo's restaurant sales have kept pace with these high growth rates, while profits have grown by more than 25 percent, compounded annually over the last five years Meanwhile, real sales growth per store has been more than twice the industry average

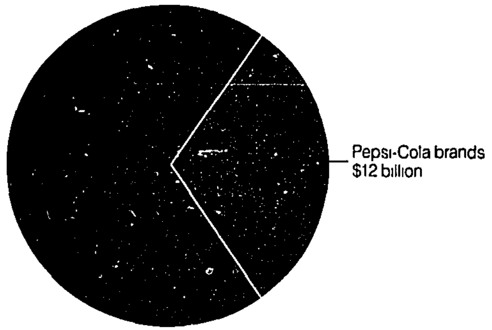
Pizza Hut is the clear market leader in the pizza segment, with more than four times as many restaurants as the nearest competitor Taco Bell is the only national system in its category

The industry is expanding as new eating patterns make fast service restaurants very attractive to today's diner

PepsiCo has a leadership position in two of the largest-selling food categories

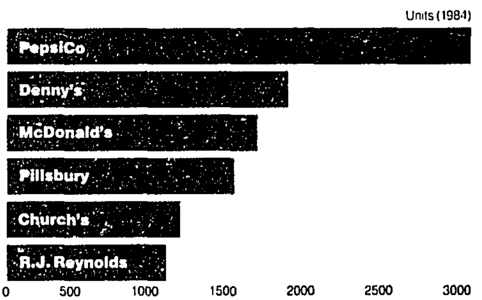


U S snack food retail sales $20 billion

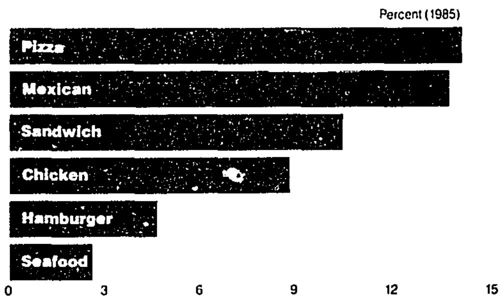


U.S soft drink retail sales $39 billion

PepsiCo restaurants: the largest U.S. company-operated system, the fastest-growing major categories



Largest U S. company-operated fast service restaurant systems



Fastest-growing major food service categories

2

For 20 years we've driven our growth through...

Commitment to building the business

Our operating managers continue to be charged with one basic objective: grow the business. They do it by developing great new products, exploiting underdeveloped markets and maintaining the vitality of established brands.

SOFT DRINKS

During 1985 Pepsi-Cola demonstrated that the century-old soft drink industry has ample room for segmentation and growth.

In the same year that Pepsi-Cola's oldest product–the nearly 90-year-old Pepsi brand–achieved record growth, we introduced the greatest soft drink innovation of the year–Slice By adding 10-percent fruit juices, we created a whole new category of soft drinks

Pepsi-Cola has a history of innovative products

The introduction in 1982 of Pepsi Free and Diet Pepsi Free effectively answered consumer desires for caffeine-free colas.

Pepsi-Cola was also the first to meet consumer preferences for a better tasting diet cola Diet Pepsi was the first cola with 100 percent NutraSweet brand sweetener.

Pepsi-Cola still sees many growth opportunities One is fountain syrup. Pepsi-Cola Food Service Division now has such major fast service restaurant accounts as Burger King, Wendy's and 7-Eleven.

Pepsi-Cola is also reaching into underdeveloped segments For example, in the vending channel, an important Pepsi-Cola innovation is the Compact Vendor. This small yet efficient machine can fit where large vending machines can't, and is expanding the market beyond traditional vending sites

SNACK FOODS

Frito-Lay has grown from two major brands in 1965 to seven in 1985, primarily through effective market segmentation and new products.

For example, some had thought the potato chip category had reached full potential But, in 1984, Frito-Lay developed O'Gradys brand potato chips–a thicker, crunchier chip with more potato flavor The result: Frito-Lay's seventh snack food brand that today sells more than $100 million at retail

Pepsi
Introduced 1898
$7 5 billion

Mountain Dew
Introduced 1948
$1 2 billion

Diet Pepsi
Introduced 1964
$1 5 billion

Pan Pizza
Introduced 1980
$880 million

Established Products

(Estimated 1985 retail sales)

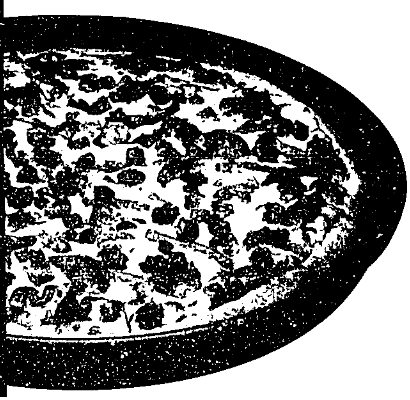
Ruffles
Introduced 1958
$495 million

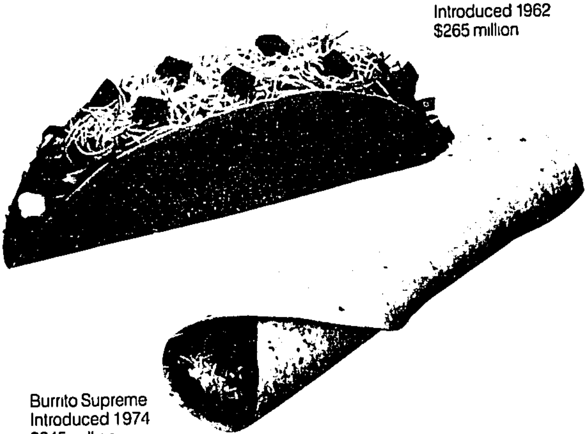
Fritos
Introduced 1932
$365 million

Chee•tos
Introduced 1948
$230 million

Lay's
Introduced 1932
$510 million

Doritos
Introduced 1961
$715 million





Taco Bell taco
Introduced 1962
$265 million

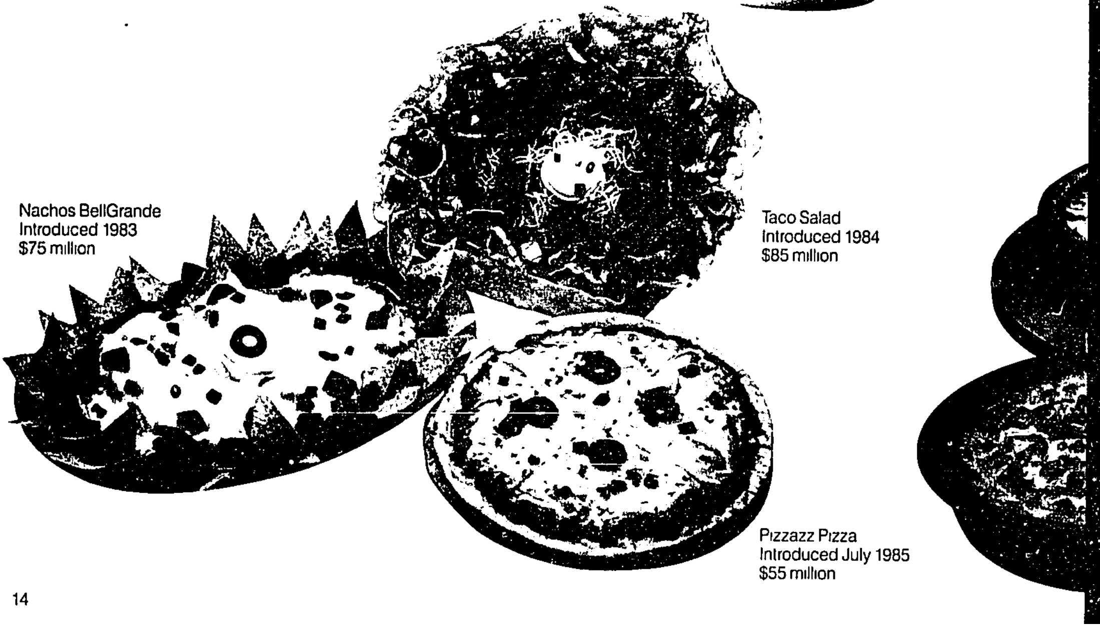
Burrito Supreme
Introduced 1974
$245 million

2 *Continued*

Pepsi Free
Introduced 1982
$720 million

Slice
Introduced 1984
$465 million

O'Gradys
Introduced 1984
$170 million



Nachos BellGrande
Introduced 1983
$75 million

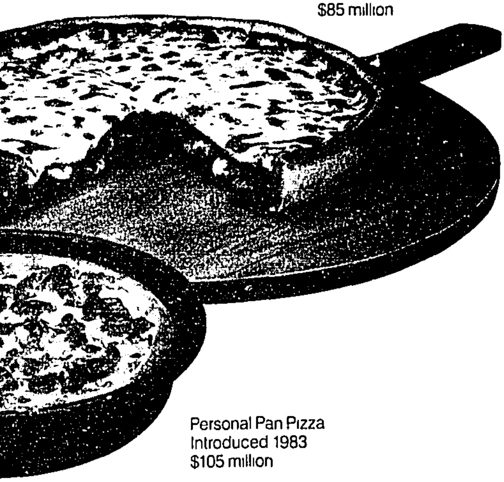
Taco Salad
Introduced 1984
$85 million

Pizzazz Pizza
Introduced July 1985
$55 million

New Products Introduced Since 1980
(Estimated 1985 retail sales)

Tostitos
Introduced 1981
$190 million

Priazzo Italian pie
Introduced June 1985
$85 million



Personal Pan Pizza
Introduced 1983
$105 million

Frito-Lay also maintains the strength of its brands by developing new seasonings and varieties. This strategy has resulted in a string of successful products that in 1985 included Fritos brand Chili Cheese corn chips, Doritos brand Cool Ranch tortilla chips, and Lay's brand Jalapeno and Cheddar potato chips.

At year-end Frito-Lay began a program of product development outside its traditional area to ensure long-term growth and vitality. Six new products have already been introduced into test market. Among these exciting product entries are McCracken's brand apple chips, a crunchy, great-tasting product made from real apples, and Rumbles brand, a bite-sized granola snack nugget.

These snack food strategies are working overseas as well. From a very small beginning, we are growing our international snack food business so that today it is twice as big as Frito-Lay was in 1965.

RESTAURANTS

Both Pizza Hut and Taco Bell grow their businesses through new restaurants, new products and new marketing ideas. And nobody does it better.

The major news in the industry in 1985 was our introduction of Priazzo Italian pie. This very successful product has a top and bottom crust, with a tasty variety of fillings such as meat, cheese and mushrooms. The top is covered with a spicy sauce and cheese.

Pizza Hut has a record of innovation. In 1980 Pizza Hut introduced Pan Pizza—a deep-dish pie that was an immediate success.

Next, Pizza Hut developed Personal Pan Pizza, an individual-sized pizza, especially suitable for lunchtime. The new product transformed the traditional pizza business into the mainstream of the fast service restaurant industry.

Now Pizza Hut is developing a delivery business. This segment has been growing more than twice as fast as the overall pizza market.

Internationally, Pizza Hut is reaching a growing number of consumer markets. For example, there is delivery in Australia, fast service in Puerto Rico, carry-out in the Middle East, pizza at pubs in the United Kingdom and self-service in Venezuela.

Like Pizza Hut, Taco Bell has creatively thrust itself into the mainstream of fast service restaurants.

Until 1982 Taco Bell's growth was primarily driven by one product—the taco. Today, the consumer can choose from a varied menu of delicious products, such as nachos, Taco Salad and Pizzazz Pizza, a unique, double tortilla crust pizza product.

3

For 20 years we've driven our growth through...

Powerful systems and superb execution

Our success is based on very complex but very efficient distribution and sales systems–our franchised bottling and restaurant operations and a store-door snack food delivery network. They provide strong competitive advantages. And our ability to quickly and effectively execute maximizes the benefit of these systems.

SOFT DRINKS

For more than 80 years Pepsi-Cola's operations have been based on a franchise system This unique partnership combines the resources of a big national company with the skills and talents of local entrepreneurs

Local franchised bottling companies, independently owned and operated, produce and distribute Pepsi-Cola products in their territories. Only such a system of shared responsibility, risk and opportunity can handle the immense size, investment, marketing and distribution needs of Pepsi-Cola's soft drink business Through this network Pepsi-Cola products are bottled in 121 countries and territories. In the United States alone, more than 200 bottlers produce and market Pepsi-Cola products

PepsiCo not only franchises bottling territories, it also is a bottler itself–the largest in the world Through the Pepsi-Cola Bottling Group (PBG), we make and market nearly one-quarter of U S Pepsi-Cola products. This network includes more than 9,000 employees and 22 manufacturing sites.

In fact, over the last decade, PBG has become one of Pepsi-Cola's best bottlers Its sales volumes have outpaced even the outstanding performance of the franchise system And PBG bottlers are among those achieving awards for highest per capita growth rates

SNACK FOODS

When it comes to executional excellence, Frito-Lay is unique Frito-Lay excels in its ability to manufacture and deliver products to more places and more people than anyone else, and to do it profitably In fact, Frito-Lay is the only national store-door delivery salty snack food company in the United States

The snack food industry is built on the need to deliver fresh product This means most snack companies can market only near their manufacturing plants

But Frito-Lay's complex, interwoven network of manufacturing and distribution centers connects nearly 1,700 facilities throughout the country.

Then its huge store-door delivery salesforce takes over.

Acting as independent entrepreneurs, each member of Frito-Lay's route salesforce is motivated to sell, stock and merchandise Frito-Lay products in one of the most effective distribution systems ever devised to ensure freshness and widespread market penetration

Only a system this efficient could take a major new product and introduce it completely into national distribution in a matter of weeks, as was done with O'Gradys brand potato chips in 1984

RESTAURANTS

PepsiCo has the largest system of company-operated restaurants in the United States, with more than 3,500 company-managed units The Pizza Hut and Taco Bell systems also include more than 3,700 restaurants operated by franchisees Both systems are rapidly adding new units.

In the restaurant industry, execution means paying close attention to detail In order to receive incentive compensation, our restaurant managers must not only exceed their sales goal, their restaurants must also achieve high standards of quality, service and cleanliness

In 1985 Pizza Hut demonstrated operational excellence by successfully introducing Priazzo Italian pie–a brand new product concept involving specialized technology Only an excellent executional system could introduce such a new concept nationwide in only a few weeks

Similarly in 1983, when Pizza Hut introduced Personal Pan Pizza virtually overnight, it required more than just a new product Fast service, quality and price all were important And Personal Pan Pizza has grown our lunch business more than 70 percent since its introduction

Taco Bell's strong operating system is helping it become a mainstream fast service restaurant choice Over the last three years, Taco Bell has been changing its image and introducing exciting new menu selections such as Taco Salad and Pizzazz Pizza

All the while Taco Bell continues to pride itself on providing freshly-made products and maintaining service speed The system even sponsors a nationwide competition to recognize and encourage efficiency

Exceptional execution–Frito-Lay's manufacturing and store-door delivery systems move product from farm to store shelf in a few short weeks The operations are incredibly complex–with 38 plants manufacturing nearly 100 products in 240 package sizes, shipped to 1,650 distribution centers Efficiency is equally impressive, with the 9,500-person salesforce making more than two million deliveries each month–and filling the exact order 99 8 percent of the time

4

For 20 years we've driven our growth through...

Aggressive marketing of very big brands

We have an outstanding record of building widespread recognition of major brand names through distinctive and innovative advertising and promotions.

SOFT DRINKS

There are many well-known brands in the United States, but few come close to the enormous size and consumer equity of PepsiCo brands. For example, Pepsi is the number one branded product in U.S. foodstores In 1985 it had retail sales of $7.5 billion in all distribution channels.

But more than just brand Pepsi, we have five additional big soft drink brands with U.S retail sales that exceed $350 million each: Slice, Mountain Dew, Diet Pepsi, Pepsi Free and Diet Pepsi Free. That's big brand marketing! And they are not just big Each brand has a unique and compelling identity.

Pepsi-Cola advertising is the best-remembered in the world and the most admired Over the years it has won a phenomenal number of awards, including more than 100 in 1985.

It began with the two-decade "Pepsi Generation" campaign, captured headlines in 1985 with such top talent as Lionel Richie and Michael Jackson, and continues today with stars such as Don Johnson, Glenn Frey, Michael J Fox and Billy Crystal. Pepsi-Cola remains on the leading edge of advertising

SNACK FOODS

Some 50 grocery food brands have annual retail sales of more than $100 million. Frito-Lay has seven of these brands: Doritos tortilla chips, Fritos corn chips, Lay's potato chips, Ruffles potato chips, Chee•tos cheese flavored snacks, Tostitos tortilla chips and O'Gradys potato chips. Again, that's big brand marketing!

The continuing development of these brands is one key to Frito-Lay's success Over the last five years, Frito-Lay has spent nearly $1 billion in marketing support.

Advertising and promotion have given each brand a unique and high quality personality Consumers still remember such well-known campaigns as Bert Lahr's "Betcha can't eat just one" for Lay's brand potato chips.

In addition strong local promotions, couponing and displays increase consumer purchases. These typically yield several times normal volume

RESTAURANTS

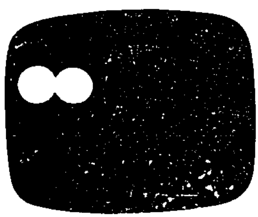
Over the last decade, Pizza Hut and Taco Bell have created a revolution in their respective restaurant categories. They have introduced such unique product concepts as Pan Pizza, Personal Pan Pizza, Priazzo Italian pie, Taco Light, Taco Salad, Nachos BellGrande and Pizzazz Pizza

To build on their leading-edge position, each chain spends more in media advertising than all their competitors combined.

In 1985 Pizza Hut introduced compelling new advertising The "Pizza Hut People" campaign, featuring celebrities eating Pizza Hut pizzas, projects an innovative, contemporary and high quality image.

Taco Bell's advertising has been a significant factor in its success in moving the system into the mainstream of consumer fast service restaurant choices Its "Just Made For You" campaign shows fresh, familiar ingredients–beef, cheese, lettuce and tomato –being prepared in exciting, different ways

PepsiCo builds its big brand names with some of the best-known advertising in the world Above, "Archaeology" for Pepsi-Cola was voted the best commercial—of all categories—at the Cannes Film Festival Below, Lionel Richie and a confused "Wilber" for brand Pepsi and "Mr Ed" for Frito-Lay's Tostitos brand tortilla chips Opposite page, from the "Pizza Hut People" campaign The MacKenzie Brothers, Martin Mull, Rita Moreno and Marvelous Marvin Hagler



For 20 years we've driven our growth through...

Financial strength and flexibility

Always a goal... PepsiCo over the last decade has truly begun to develop great financial strength. For example, our strong financial position in 1985 enabled us to fund record capital investments ($786 million) and record dividends ($161 million) and to repurchase 7.3 million shares of our stock, sharply increasing shareholder value. We did all this and still were able to make commitments for major acquisitions of related businesses ($1.2 billion when completed).

SOFT DRINKS

Twenty years ago PepsiCo recognized that a consumer products company could not achieve lasting success without the financial resources that permit quick response to ever-changing markets.

This is especially true in soft drinks, and, because of our growing financial resources, we've been able since 1965 to invest more than $1.2 billion in our domestic soft drink operations.

A major financial strategy in soft drinks is selective investment to upgrade and strengthen our bottler network. For example, in 1985 we agreed to acquire MEI Corporation, our third largest franchisee.

In early 1986 we announced an agreement to acquire the franchise beverage business of The Seven-Up Company.

These actions are designed to strengthen the bottler networks and improve volume and profit growth in important markets.

SNACK FOODS

In the last 20 years, PepsiCo has invested more than $1.6 billion in our snack food businesses.

The principal purposes have been to create new products and to expand capacity. In the United States capacity has increased 16 percent in just the last five years. Internationally, aggressive expansion of new facilities and production lines during the same period has increased capacity by more than 75 percent.

Productivity improvements are another important reason for investment. These include new equipment such as highly accurate computer-controlled weighers, energy conservation systems, and hand-held computers used by the salesforce to combine invoicing and inventory into a one-step process.

Frito-Lay's goal is to generate productivity gains over a five-year period to offset all cost increases due to inflation. Over the last three years, cost reduction projects have resulted in cumulative savings of more than $200 million.

RESTAURANTS

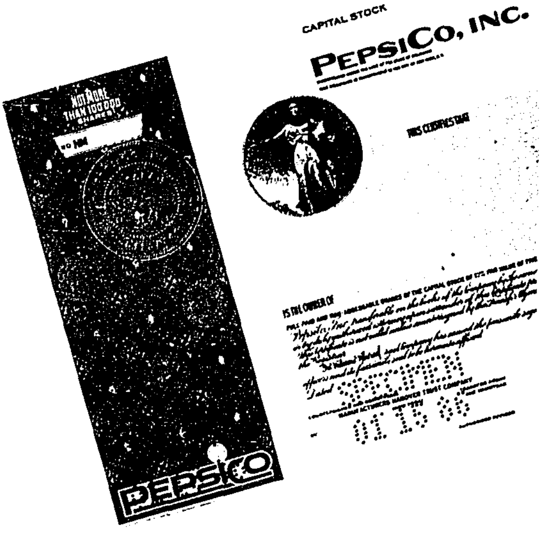
Since setting up our restaurant operations in 1977, we have invested more than $1.3 billion and have doubled the number of restaurants in our systems.

We've recently increased our rate of unit additions by buying existing restaurant chains and converting them to Pizza Hut or Taco Bell restaurants.

This approach is more efficient and less costly than building, and we can select proven high-volume locations. In the last two years, we have converted almost 200 restaurants. And we added all these restaurants at the same time as we were introducing new products, refurbishing existing restaurants, sharply expanding our advertising and adding delivery service.

Internationally, we continue to form joint ventures in selected key markets to increase our penetration and development rate. Recent examples include the 1985 partnership with the Tengelmann Group in Germany, the 1982 partnerships with Whitbread and Company, Ltd., in the United Kingdom, and Gruma, S.A., in Mexico.

We are also investing in delivery-only units and in existing restaurants through refurbishing and addition of drive-thru windows.



PepsiCo's financial strength enables us to undertake several major investments simultaneously In 1985 these included major additions to both restaurant systems and important renovations at Taco Bell, expanding our soft drink business in China, and repurchasing 7 3 million shares of stock to further enhance shareholder value


SOFT DRINKS

Operating Highlights

Pepsi-Cola USA/Pepsi-Cola Bottling Group/Pepsi-Cola International

Nineteen eighty-five was one of the most exciting years in Pepsi-Cola history. Brand Pepsi became the leading soft drink in the United States.

In the foodstore segment–the largest single distribution channel–brand Pepsi widened its lead It grew two times the rate of the regular cola category and gained its largest share advantage in history Market share for total Pepsi-Cola brands also rose to a new high

Aggressive Pepsi-Cola advertising and marketing programs continue to capture the country's attention as well as new drinkers for brand Pepsi New campaigns rapidly responded to confused consumers who pondered our principal competitor's introduction of a reformulated cola followed by their reluctant return of the renamed but original product.

At the same time in 1985, Diet Pepsi became America's fastest-growing major soft drink brand. To accelerate that growth in 1986, we introduced bold new graphics designed to appeal to an even wider audience

Slice is perhaps the most innovative soft drink in the 100-year history of the industry Launched in late 1984, Slice brand achieved nearly a three percent share in its markets–a major achievement in a highly competitive industry

A soft drink with 10-percent fruit juices, Slice and Diet Slice created a whole new category of soft drinks and are attracting a new generation of consumers to the soft drink market With that type of favorable consumer response, we've already scheduled new flavors for 1986 Mandarin Orange Slice, Cherry Cola Slice and Apple Slice, in regular and diet versions

In the soft drink industry, it is clearly advertising that drives market growth and generates enthusiasm among bottlers and consumers alike For the second year, Pepsi-Cola's innovative leadership in this arena was clearly evidenced in its award-winning advertising "Pepsi The Choice of a New Generation " led the way. This campaign is already an advertising classic And in 1985 one of its commercials, "Archaeology," was judged the best advertisement in the world–in any product category–at the Cannes Film Festival.

In addition to major gains in foodstores, Pepsi-Cola also made great progress in fountain syrup Volume again grew faster than the industry, led by strong local account growth During the year Wendy's, one of Pepsi-Cola's largest customers, became the first major restaurant system to begin serving Slice.

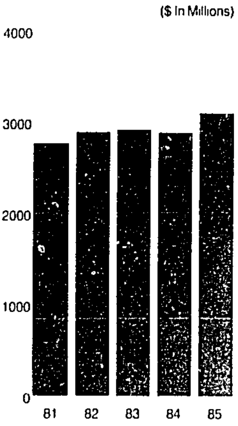
Outside the United States, Pepsi-Cola focused on major markets that present the best opportunity for growth. More than 25 countries–including Egypt, Brazil, Australia and the Soviet Union–achieved double-digit volume growth in 1985 And, in Canada we were the first to introduce a cherry cola

We are also seeking major new opportunities for future growth, like China A new bottling plant in Guangzhou will increase Pepsi-Cola production capacity to over 10 million cases annually Pepsi-Cola is now the largest multinational producer of soft drinks in China, a vast market of more than one billion people

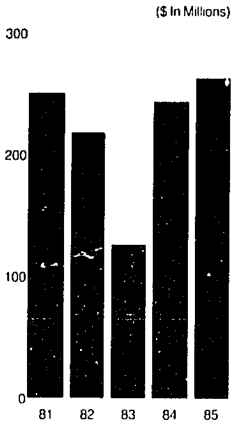
And in another huge market, the Soviet Union, PepsiCo announced a trade agreement which will nearly double Pepsi-Cola sales there over the next several years.

The bottle with the distinctive swirl exemplified Pepsi-Cola's image of the 60s

Net Sales



Operating Profits*



*Excluding unusual credits and charges

Financial Review

Soft drinks sales increased eight percent in 1985 This solid sales increase reflected significant domestic growth, partially offset by lower foreign sales Sales in 1984 declined one percent primarily because sales from several company-owned foreign bottling operations, which were subsequently refranchised (the Refranchising Program), were included for only the first half of the year compared to the full year in 1983 The 1985 domestic sales increase reflected substantially increased sales to the franchised bottlers and strong sales gains by Pepsi-Cola's company-owned domestic bottling operations Foreign sales in 1985 were slightly lower than 1984 due to the inclusion in the first half of 1984 of sales from the bottling operations in the Refranchising Program. Total domestic bottler case sales advanced 10 percent in 1985, following an eight percent increase in 1984. The substantial volume growth in 1985 was a result of the successful introduction of Slice, the continued significant growth of Diet Pepsi and the relatively strong performance of brand Pepsi in its category The domestic volume growth in 1984 was led by strong sales of brand Pepsi, Diet Pepsi and fountain syrup Foreign bottler case sales increased two percent in 1985, led by improved performances in Brazil, Canada, Egypt, Iraq and Mexico The 1985 foreign volume increase was the first since 1982 Foreign bottler case sales in 1984 were about even with 1983 results

Segment operating profits increased seven percent in 1985 excluding the refranchising credit (charge) recorded in 1985 and 1984 (For further detail on the refranchising credit (charge) see Notes to Consolidated Financial Statements on page 43) Both domestic and foreign results were adversely impacted by a one-time charge recorded in the fourth quarter for expenses related to the planned move to a new soft drinks headquarters in Somers, N Y Excluding this charge, operating profits advanced 10 percent. Domestic profits increased modestly in 1985, reflecting higher levels of competitive marketing and promotional spending and other increased costs, primarily associated with the introduction of Slice Foreign profits were nearly double those in 1984, which included significant first-half operating losses from the bottling operations in the Refranchising Program Results in 1985 include a lower net foreign exchange gain due primarily to the inclusion in the first half of 1984 of gains from the bottling operations in the Refranchising Program

Operating profits in 1984 were almost twice those in 1983, reflecting a recovery in many international markets, compared to a depressed 1983 when large losses were incurred Domestic profits in 1984 improved only modestly as strong volume gains and price increases were largely offset by higher ingredient costs and substantially increased levels of competitive spending.


SNACK FOODS

Operating Highlights

Frito-Lay/PepsiCo Foods International

In many ways 1985 was the most important year in the last decade for Frito-Lay Not only did the company introduce a series of products that will lead it into the next decade of growth, but it made fundamental changes in the structure of its renowned sales organization.

In late 1985 Frito-Lay simultaneously introduced several important products into test market

Some brands are designed to open up new segments in the traditional salty snack market. These include Santitas brand, a restaurant-style tortilla chip; Delta Gold brand, a premium potato chip, and Kincaid's brand Homestyle potato chips

But Frito-Lay also introduced six new products that are very different from its existing line of salty snacks These are designed to expand Frito-Lay's position in the overall snack food business–a $20 billion market.

And they are unique product offerings–such as Stuffers brand filled snacks and Rumbles brand, a granola snack.

Perhaps the most important development of 1985 was the strategic leap forward taken by Frito-Lay's already legendary store-door delivery system. To more effectively serve the different needs of large and small retail outlets, the salesforce was split in two distinct segments. supermarket and route sales

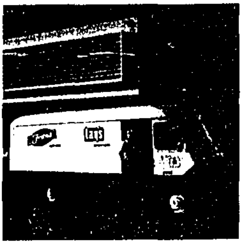
This action allows one segment of the Frito-Lay salesforce to focus as never before on supermarkets, the largest and fastest-growing distribution channel. Meanwhile, other members of the route salesforce can concentrate on more complete coverage of the smaller route customer channel.

During this period of major new product activity and sales restructuring, Frito-Lay also was able to increase its support of its seven major brands. These so called "core" products account for nearly 80 percent of total volume, growth and profits

One important result of this continuing attention to established brands is the growth in potato chip volume In 1985 Lay's brand was the fastest growing potato chip in the market The resurgence in this category began with the 1984 introduction of O'Gradys brand potato chips. Now Frito-Lay has introduced new flavors, such as Ruffles brand Cheddar and Sour Cream and O'Gradys brand Hearty Seasonings, to build the momentum

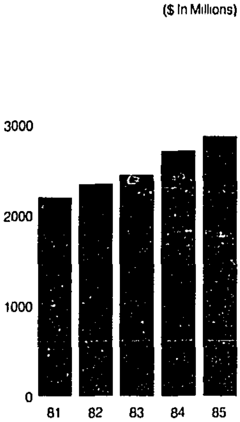
PepsiCo Foods International is also growing rapidly, with snack food operations in 10 key countries. PFI's strategy is to introduce into foreign markets products and marketing programs that have proven successful domestically

For example, Ruffles brand potato chips has been introduced in several countries, as has Doritos brand. At the same time, PFI is flexible enough to meet local market desires for specialty products.

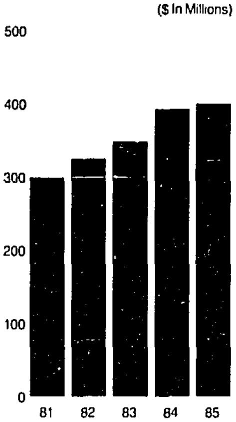


Frito-Lay's famed salesforce has been on the road since the company's beginnings

Net Sales



Operating Profits



Financial Review

Sales for the snack foods segment increased five percent in 1985, following strong growth of 11 percent in 1984 The modest sales growth in 1985 reflected significant international growth, partially offset by slower unit growth at Frito-Lay Frito-Lay's core brand supermarket unit volume rose three percent, led by solid growth in the potato chip category, moderated by the soft performance of corn and tortilla chips. Frito-Lay's single-serve snack line also contributed to sales growth. In 1984 core brand supermarket unit volume improved six percent, primarily as a result of the successful introduction of O'Gradys brand potato chips Foreign unit volume increased 20 percent in 1985, after a 10 percent increase in 1984, primarily from significant gains recorded in Mexico for both 1985 and 1984.

Operating profits for the segment increased two percent in 1985, including a one-time charge in the fourth quarter related to packaged cookies at Frito-Lay. Excluding this charge, total operating profits advanced six percent. Frito-Lay's profits excluding the one-time charge rose modestly. Frito-Lay benefited from favorable raw material costs and manufacturing efficiencies, which were partially offset by higher operating expenses. Foreign operating profits in 1985 substantially exceeded results in 1984, principally in Mexico, where increased profits were due to volume increases, improved margins and significantly increased Mexican foreign exchange gains.

Snack foods recorded significant profit growth of 13 percent in 1984. Frito-Lay benefited from strong volume increases and improved manufacturing and distribution productivity, partially offset by increased costs associated with new product introductions and raw materials. Foreign snack foods also recorded substantial improvement, principally in Mexico.

Operating Highlights

Pizza Hut/Taco Bell/ PepsiCo Food Service International/La Petite Boulangerie

PepsiCo's restaurant systems achieved strong growth again in 1985 Their success reflects a well-balanced and superbly executed strategy of introducing new products and concepts, communicating a fresh image and adding a record number of restaurants

Pizza Hut's growth again surpassed the restaurant industry's And Pizza Hut maintained its leadership position in innovation with the midyear introduction of Priazzo Italian pie

This unique double-crusted Italian pie created an entirely new mealtime choice, and is increasing both trial and repeat visits to Pizza Hut restaurants

Pizza Hut also expanded into the very important and rapidly-growing delivery market More than 80 delivery units were built in 12 test markets, and there are plans for significant expansion of this business in 1986

Pizza Hut's success also reflects a bold new approach to advertising–a national campaign that projects its confident, quality image "Pizza Hut People" features celebrities eating and spontaneously commenting on Pizza Hut pizza It is one of 1985's most popular and best-remembered advertising campaigns

Taco Bell also introduced a wave of new products to enhance its position as a mainstream fast service restaurant These included combination platters, Fiesta Salad and Pizzazz Pizza, a unique Mexican pizza-style product featuring two tortilla crusts These are bringing new consumers, including more families, into the restaurants

In its drive to become a mainstream fast service restaurant choice, Taco Bell is adopting an important new image A redesigned logo, improved building design decor, new product packaging and crew uniforms–all these elements are successfully raising consumer awareness of the Taco Bell system and projecting the high quality of the restaurant and its products.

We drive the growth of our restaurant business not only through new products and marketing programs, but also by adding new units

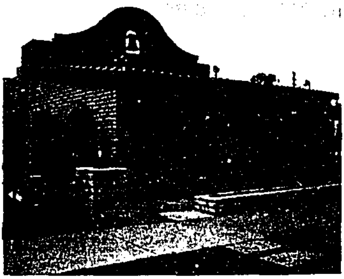
Pizza Hut built 63 company-operated and 118 franchised restaurants, bringing the total system to 4,482 units Taco Bell added 207 company-operated restaurants and 140 franchised units for a total of 2,173.

In 1986 PepsiCo anticipates an even more aggressive program of restaurant additions And it also has agreed to acquire Pizza Hut's largest franchisee, A&M Food Services, Inc , which operates 150 restaurants

Outside the United States, PepsiCo Food Service International continues to grow rapidly. In 1985 it opened more than 100 new restaurants, many in new markets PepsiCo now operates or franchises 518 restaurants in 35 countries

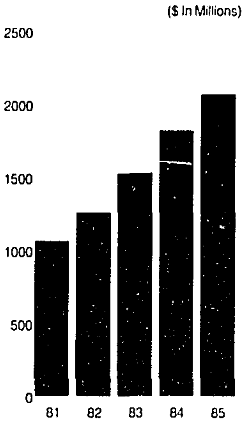
As one important measure of success, store volumes and real growth in key international markets continue to outpace even the strong U S. averages

In fact, the highest-volume Pizza Hut in the world is in Hong Kong Its volume is nearly four times that of the average U S Pizza Hut.

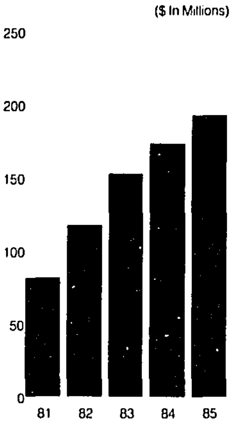


Dramatic changes from this look of the past has helped Taco Bell move into the mainstream of fast service restaurants

Net Sales



Operating Profits

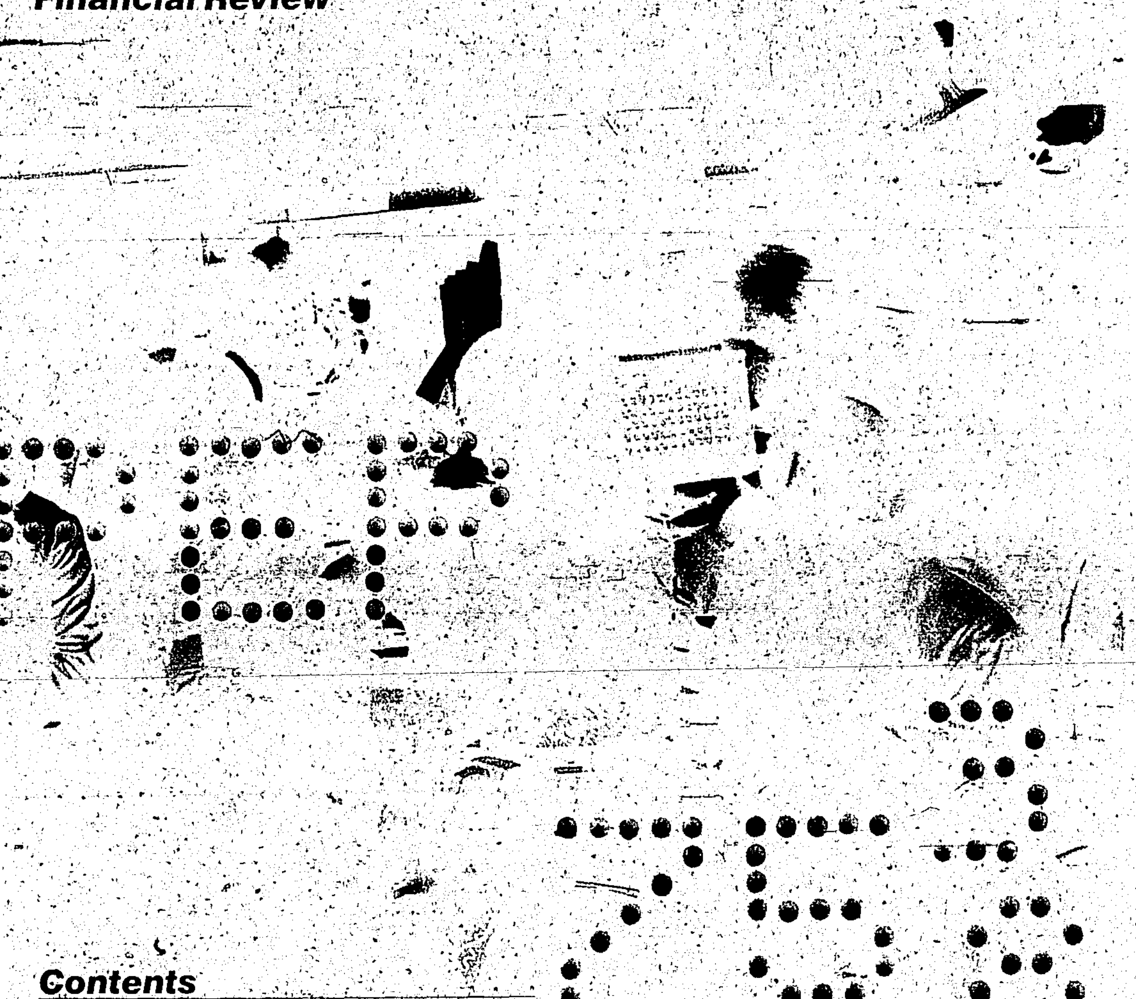


Financial Review

Sales increased 14 percent in 1985, following a 20 percent increase in 1984 The strong sales growth in 1985 was primarily attributable to new stores, new products and pricing. Combined average store sales at domestic company-operated Pizza Hut and Taco Bell restaurants advanced five percent in 1985, after a 12 percent increase in 1984. Average real volume per store increased one and a half percent in 1985, following a seven percent increase in 1984. Pizza Hut had solid real growth, primarily a result of the successful introduction of Priazzo Italian pie in the second half of 1985. Taco Bell's real volume per store was about even with an exceptionally strong performance in 1984, when several new products were successfully introduced

Operating profits advanced 11 percent in 1985, following a 14 percent increase in 1984. Profits were up at Pizza Hut, Taco Bell and international restaurant operations, while losses increased at La Petite Boulangerie The increase at Pizza Hut reflected lower food costs and improved control of operating expenses, offset slightly by increased start-up costs associated with Pizza Hut's expanding test of its delivery service concept. Taco Bell's results were favorably impacted by a one-time gain from the sale of an office building. Operating costs were up significantly at Taco Bell, reflecting increased investments in new product development and new and existing stores International restaurant operations improved considerably in 1985, from a small base in 1984 The significant profit increase in 1984 was primarily due to outstanding results at Taco Bell, offset somewhat by a flat performance at Pizza Hut. Profits resulting from the sale of company-owned restaurants amounted to less than five percent of restaurants operating profits in 1985, 1984 and 1983

Financial Review



Contents

Report of Chief Financial Officer

To Our Shareholders·

Management is responsible for the integrity and objectivity of the financial statements and related notes To meet this responsibility, we maintain a system of internal control, supported by formal policies and procedures and an internal audit program designed to monitor and report on the adequacy of and compliance with our internal controls, policies and procedures We believe the established system of internal control provides reasonable assurance that assets are safeguarded, transactions are recorded in accordance with our policies and the financial information is reliable.

The financial statements have been prepared in conformity with generally accepted accounting principles applied on a consistent basis, and include amounts based upon our estimates and judgments, as required. The financial statements have been audited by certified public accountants who have expressed their opinion, presented below, with respect to the fairness of the statements Their examination included a review of the system of internal control and tests of transactions to the extent they considered necessary to render their opinion

The Audit Committee of the Board of Directors is composed of non-employee directors. The Audit Committee meets on a regular basis with management, our internal auditors and certified public accountants to review audit plans, results and recommendations, as well as the effectiveness of our system of internal control.

Both our certified public accountants and internal auditors have free access to the Audit Committee.

Michael H Jordan
Executive Vice President
and Chief Financial Officer

Report of Certified Public Accountants

Board of Directors and Shareholders
PepsiCo, Inc.

We have examined the accompanying consolidated statement of financial condition of PepsiCo, Inc. and subsidiaries at December 28, 1985 and December 29, 1984, and the related consolidated statements of income, changes in financial condition and shareholders' equity for each of the three years in the period ended December 28, 1985, appearing on pages 36, 38, 40 and 42 through 51 Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances

In our opinion, the statements mentioned above present fairly the consolidated financial position of PepsiCo, Inc and subsidiaries at December 28, 1985 and December 29, 1984, and the consolidated results of operations and changes in financial position for each of the three years in the period ended December 28, 1985, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company

277 Park Avenue
New York, New York
February 4, 1986

Consolidated Statement of Income

(in thousands except per share amounts)
PepsiCo, Inc and Subsidiaries
Years ended December 28, 1985 (fifty-two weeks), December 29, 1984 (fifty-two weeks) and December 31, 1983 (fifty-three weeks)

	1985	1984	1983
Net Sales	**$8,056,662**	$7,451,106	$6,899,884
Costs and Expenses			
Cost of sales	**3,148,261**	2,974,458	2,821,816
Marketing, administrative and other expenses	**4,171,339**	3,763,974	3,537,556
Interest expense	**195,378**	205,099	175,232
Interest income	**(96,382)**	(86,117)	(53,614)
	7,418,596	6,857,414	6,480,990
Income From Continuing Operations Before Refranchising Credit (Charge) and Income Taxes	**638,066**	593,692	418,894
Refranchising credit (charge)	**25,900**	(156,000)	–
Income From Continuing Operations Before Income Taxes	**663,966**	437,692	418,894
Provision for federal and foreign income taxes	**243,885**	162,677	140,602
Income From Continuing Operations	**420,081**	275,015	278,292
Discontinued Operations			
Income (loss) from discontinued operations (net of income tax provision (benefit) of $6,716, $(61) and $359 in 1985, 1984 and 1983, respectively)	**9,609**	(47,468)	5,819
Gain (loss) from disposals (net of income tax provision (benefit) of $28,760 and $(500) in 1985 and 1984, respectively)	**114,000**	(15,000)	–
	123,609	(62,468)	5,819
Net Income	**$ 543,690**	$ 212,547	$ 284,111
Net Income (Loss) Per Share			
Continuing operations	**$4.51**	$2 90	$2 95
Discontinued operations	**1.32**	(65)	06
Net Income	**$5.83**	$2 25	$3 01
Average shares outstanding used to calculate earnings per share	**93,567**	95,827	95,480

See accompanying notes

Management's Review— Results of Continuing Operations

Net sales increased eight percent to $8 1 billion in 1985, following an eight percent increase in 1984 The increase in 1985 was driven primarily by volume gains in our domestic soft drinks, domestic restaurants and foreign snack foods businesses and small price increases in all segments Volume gains primarily reflect the impact of new products, new restaurants and strong diet soft drink growth The increase in 1984 sales reflected strong growth in the restaurants and snack foods segments and the domestic soft drinks business

Cost of sales rose at a slower pace than net sales, six percent in 1985 and five percent in 1984 The 1985 increase reflected increased volume in all segments and higher ingredient costs in the domestic soft drinks segment due to both a diet formula change to 100 percent NutraSweet brand sweetener in early 1985 and a mix shift to higher cost diet drinks and new juice-based Slice This increase was moderated by lower food and ingredient costs in the restaurants and snack foods segments, respectively The 1984 increase primarily resulted from increased volume and higher ingredient costs in the soft drinks and snack foods segments (The impact of inflation on PepsiCo's operations is discussed in the Information on the Effects of Inflation on page 52)

Marketing, administrative and other expenses increased 11 percent in 1985 following a six percent increase in 1984, reflecting the continued development and expansion of all three of PepsiCo's segments Marketing expenses increased 13 percent in 1985, following a 15 percent increase in 1984 The increase in 1985 was primarily due to higher levels of competitive spending in domestic soft drinks and increased promotional spending for new products in all segments Also contributing to the increase in marketing, administrative and other expenses were increased fixed costs, primarily due to new restaurant openings, and one-time charges recorded in the fourth quarter of 1985. A $16 million charge was recorded by Frito-Lay related to packaged cookies, and a $12 million charge was recorded related to the planned move to a new soft drinks headquarters in Somers, NY. The 1984 increase was attributable to competitive spending and new product introductions in all three segments.

Net foreign currency translation gains, which are included in marketing, administrative and other expenses, arise principally from the favorable impact of devaluation on local currency borrowings of PepsiCo's foreign operations In 1985 the gains were $32 million compared to $53 million in 1984 and $17 million in 1983 The reduction in 1985 from 1984 is primarily attributable to the Philippines, where losses were sustained in 1985 compared to gains in 1984 The increase in 1984 over 1983 was a result of losses experienced in Venezuela in 1983, increased gains in Brazil and Argentina in 1984 and gains in the Philippines in 1984 compared to a small loss in 1983.

Net interest expense (after deducting interest income) decreased 17 percent to $99 million in 1985, following a two percent decrease in 1984. International net interest expense decreased 17 percent The decrease was primarily attributable to a reduction in foreign currency borrowings, particularly in Brazil and Mexico, and lower interest rates in the Philippines. These borrowings had previously financed the now refranchised foreign bottling operations Domestic net interest expense also decreased 17 percent This was principally due to increased interest income from short-term investments and the North American Van Lines receivable Commercial paper interest expense increased as a result of higher commercial paper borrowings used primarily to finance the share repurchase program and the acquisition of the Allegheny Pepsi-Cola Bottling Company. The two percent decrease in 1984 was due to lower net domestic borrowing costs, which more than offset increased foreign currency borrowing costs The foreign borrowings were used, in part, to hedge foreign investments in certain Latin American countries and the Philippines against devaluations

Income from continuing operations before refranchising credit (charge) and income taxes increased seven percent in 1985, following a 42 percent increase in 1984 Nineteen eighty-five results reflected increases in all three segments, led by restaurants, international soft drinks and international snack foods. Results were moderated by the two one-time charges and reduced foreign currency gains Excluding the one-time charges in 1985, results were up 12 percent The significant increase in 1984 was the result of a turnaround in foreign soft drinks and snack foods operations and continued growth in domestic snack foods and restaurants operations

Refranchising credit (charge) relates to the refranchising of several company-owned foreign bottling operations (the Refranchising Program) In 1984 a charge of $156 million was recorded to cover the estimated costs of the Refranchising Program In 1985 the Refranchising Program was substantially completed, and, as a result of more favorable results than originally estimated, a $26 million credit was recorded (See Notes to Consolidated Financial Statements on page 43 for a detailed discussion of the Refranchising Program)

Provision for federal and foreign income taxes on income from continuing operations was 36 7 percent in 1985, compared to 37 2 percent in 1984 and 33 6 percent in 1983 The lower rate in 1983 reflected one-time U.S tax benefits from legal reorganizations and tax elections involving certain company-owned foreign bottling operations. Excluding the impact of the Refranchising Program, the provision for taxes was 36 5 percent in 1985 compared to 43 2 percent in 1984 The lower rate in 1985 was caused by a higher percentage of foreign income taxed at rates below the statutory federal rate of 46 percent and reduced foreign losses without tax benefit For tax purposes, foreign income includes 50 percent of the income arising from the sale in the U S domestic market of Pepsi-Cola concentrate that is manufactured in Puerto Rico under tax incentive grants

Income from continuing operations of $420 million in 1985 was up 53 percent from $275 million in 1984, which decreased one percent from $278 million in 1983 **Income per share** from continuing operations of $4 51 increased 56 percent from $2 90 in 1984 Nineteen eighty-four income per share declined two percent from the $2 95 reported in 1983 Income from continuing operations before the effects of the Refranchising Program and the one-time charges was $420 million in 1985, up 25 percent from $337 million in 1984, which increased 21 percent from $278 million in 1983 The related earnings per share was $4.51 in 1985, up 27 percent from $3 55 in 1984, which was up 20 percent from $2 95 in 1983 Nineteen eighty-five per share amounts were favorably affected by PepsiCo's repurchase of 7 3 million shares (See Notes to Consolidated Financial Statements on page 45 for additional information)

For a discussion of the results of operations of PepsiCo's business segments, see pages 24, 28 and 32

Consolidated Statement of Financial Condition

(in thousands except share amounts)
PepsiCo, Inc and Subsidiaries
December 28, 1985 and December 29, 1984

	1985	1984
Assets		
Current Assets		
Cash	$ 25,738	$ 27,501
Short-term investments	886,527	784,684
Receivable from sale of North American Van Lines	375,540	–
Notes and accounts receivable, less allowance: 1985–$30,382, 1984–$30,663	648,659	587,373
Inventories	380,096	340,689
Prepaid expenses, taxes and other current assets	477,984	232,998
Net assets held for disposal	–	289,593
	2,794,544	2,262,838
Long-term Receivables and Other Investments	232,251	254,184
Property, Plant and Equipment	2,571,773	2,115,981
Goodwill	185,716	163,904
Other Assets	76,876	79,497
	$5,861,160	$4,876,404
Liabilities and Shareholders' Equity		
Current Liabilities		
Notes payable (including current installments on long-term debt and capital lease obligations)	$ 344,137	$ 280,796
Accounts payable	621,993	487,451
Federal and foreign income taxes	123,609	117,736
Other accrued taxes	64,746	63,414
Other current liabilities	681,234	622,658
	1,835,719	1,572,055
Long-term Debt	1,035,571	536,076
Capital Lease Obligations	127,097	133,565
Other Liabilities and Deferred Credits	211,391	162,732
Deferred Income Taxes	813,700	618,600
Shareholders' Equity		
Capital stock, par value 5¢ per share; authorized 135,000,000 shares, issued 1985–95,898,068; 1984–95,164,331 shares	4,795	4,758
Capital in excess of par value	282,453	251,915
Retained earnings	2,061,442	1,678,912
Cumulative translation adjustment	(40,931)	(49,426)
Cost of repurchased shares 1985–8,191,905; 1984–1,256,768	(470,077)	(32,783)
	1,837,682	1,853,376
	$5,861,160	$4,876,404

See accompanying notes

Management's Review— Financial Condition

PepsiCo continues to maintain a strong overall financial condition as shown in its Consolidated Statement of Financial Condition at the end of 1985 and 1984. A discussion of the significant items relating to PepsiCo's financial condition and liquidity follows.

Short-term investments consist primarily of marketable securities held offshore. This portfolio has grown significantly in recent years as the result of strong operating cash flows and increased soft drink concentrate manufacturing activity in Puerto Rico where a sizeable amount of these investments are held. Funds domiciled in Puerto Rico can be repatriated as a dividend at management's discretion upon payment of a modest tollgate tax. In addition, PepsiCo has invested approximately $200 million in 1985 in secured pools of short-term third party receivables.

The $376 million **Receivable from sale of North American Van Lines** was subsequently collected in full on its scheduled due date in January 1986.

Current **Notes and accounts receivable** primarily represent amounts due from Pepsi-Cola franchised bottlers and Frito-Lay customers. Collection experience continues to be favorable.

Inventories consist primarily of raw materials and finished goods relating to the soft drinks and snack foods segments. The days sales in inventory decreased modestly in 1985.

The 1985 increase in **Prepaid expenses, taxes and other current assets** primarily represents the $160 million temporary investment in the Allegheny Pepsi-Cola Bottling Company. Also included in the account is $194 million and $176 million of the current portion of deferred income taxes, in 1985 and 1984, respectively.

Net assets held for disposal in 1984 represented the net assets of Wilson Sporting Goods and North American Van Lines, which were sold in 1985.

PepsiCo increased its net investment in **Property, plant and equipment** by $456 million, a 22 percent increase from 1984, reflecting its strong commitment to its businesses. While investment continued in all business segments, the fast-growing restaurants segment has accounted for the largest percentage of capital additions for the last several years.

The increase in **Goodwill** is attributable to a number of small franchised bottler and restaurant acquisitions, partially offset by amortization.

Notes payable increased $63 million in 1985 principally due to the reclassification from long-term debt of $150 million of 10⅛ percent Notes maturing in 1986 reduced by the retirement of $100 million of 8¼ percent Notes.

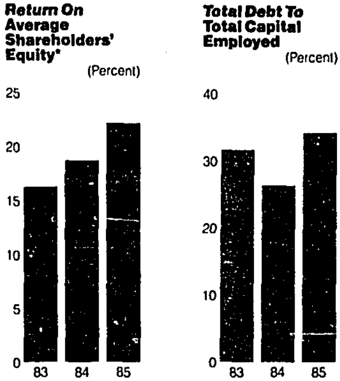
Accounts payable consist primarily of trade payables for raw materials and services in all segments. The increase in 1985 over 1984 is the result of general growth of the business.

Other current liabilities primarily represent accruals for employee compensation and compensation related costs, advertising and marketing programs, insurance costs, accrued interest on borrowings and the net liability from the Refranchising Program. (See Notes to Consolidated Financial Statements on page 43 for additional information.)

Long-term debt represents PepsiCo's borrowings with maturity dates one or more years in the future. The 1985 increase in long-term borrowings was primarily caused by the issuance of $603 million of commercial paper, used to finance the share repurchase program and the acquisition of the Allegheny Pepsi-Cola Bottling Company (see Notes to Consolidated Financial Statements on page 45 for additional information), reduced by the reclassification of $150 million of 1986 maturities to notes payable. The commercial paper has been classified as long-term as it is PepsiCo's intention to refinance these borrowings on a long-term basis during 1986.

Deferred income taxes increased by $195 million, primarily related to the tax attributes associated with tax lease transactions ($114 million) and depreciation ($41 million).

Shareholders' equity decreased $16 million during the year. The decrease is principally attributable to PepsiCo repurchasing 7.3 million shares for $458 million and $161 million of cash dividends, substantially offset by 1985's net income. (See the Consolidated Statement of Shareholders' Equity on page 42 for additional information.)



*Income from continuing operations excluding refranchising credit (charge)

Based on income from continuing operations before the refranchising credit (charge), the return on average shareholders' equity was 22.0 percent in 1985 compared to 18.5 percent and 16.2 percent in 1984 and 1983, respectively. The increase in 1985 is due to the significant increase in income coupled with the impact of the share repurchase program. After the refranchising credit (charge), return on average shareholders' equity was 22.8 percent and 15.1 percent in 1985 and 1984, respectively.

PepsiCo's ratio of total debt (including capital lease obligations) to capital employed (which is total debt, deferred income taxes, other liabilities and deferred credits and shareholders' equity) increased to 34.5 percent in 1985 from 26.5 percent in 1984, reflecting the borrowings used to finance the share repurchases and the Allegheny Pepsi-Cola Bottling Company acquisition. The 1984 ratio, the lowest in over five years, reflected a net decrease in borrowings of $125 million during 1984 and strong growth in internally generated capital. In 1983 the ratio was 31.7 percent.

Consolidated Statement of Changes in Financial Condition

(in thousands)
PepsiCo, Inc and Subsidiaries
Years ended December 28, 1985 (fifty-two weeks), December 29, 1984 (fifty-two weeks) and December 31, 1983 (fifty-three weeks)

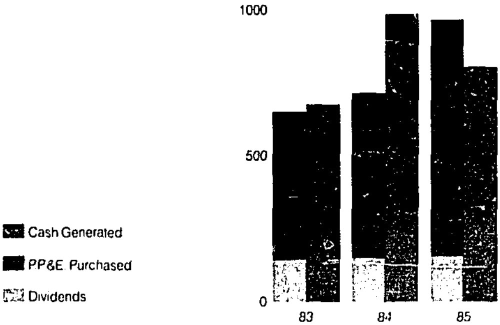
	1985	1984	1983
Cash was Generated by (Used for):			
Continuing Operations			
Income	**$ 420,081**	$ 275,015	$ 278,292
Depreciation and amortization	**290,819**	249,604	232,852
Deferred income taxes	**81,100**	121,300	60,200
Refranchising (credit) charge	**(14,900)**	62,000	–
Changes in operating working capital accounts (see details below)	**(68,694)**	186,600	(9,004)
Other non-cash charges and credits, net	**95,840**	85,360	107,894
Cash generated by continuing operations	**804,246**	979,879	670,234
Discontinued operations:			
Cash generated by (used for) discontinued operations	**16,507**	(63,211)	30,001
Wilson restructuring charge	**–**	59,300	–
Other, net	**(15,147)**	2,872	(29,755)
Cash generated by (used for) discontinued operations	**1,360**	(1,039)	246
Investment activities.			
Purchases of property, plant and equipment	**785,896**	555,802	503,352
Receivable from sale of North American Van Lines	**375,540**	–	–
Proceeds from sale of North American Van Lines	**(368,950)**	–	–
Allegheny Pepsi-Cola acquisition	**160,000**	–	–
Proceeds from the sale of Wilson Sporting Goods	**(134,100)**	–	–
Proceeds from sales of property, plant and equipment	**(49,459)**	(42,210)	(42,910)
Miscellaneous, net	**15,605**	26,828	(89,997)
Cash used for investment activities	**784,532**	540,420	370,445
Financing activities			
Increase in long-term debt	**689,930**	41,356	62,257
Purchase of capital stock	**(458,171)**	–	–
Reductions of long-term debt and capital lease obligations	**(220,527)**	(197,849)	(135,363)
Cash dividends	**(161,054)**	(154,624)	(151,271)
Deferred income taxes arising from tax leases	**114,035**	115,584	105,347
Increase in notes payable	**63,341**	5,501	87,372
Issuance of capital stock	**51,452**	11,306	5,903
Cash generated by (used for) financing activities	**79,006**	(178,726)	(25,755)
Resulting in:			
Increase in cash and short-term investments during the year	**$ 100,080**	$ 259,694	$ 274,280
Details of Changes in Operating Working Capital Accounts Which Generated (Used) Cash:			
Notes and accounts receivable	**$ (61,286)**	$ (45,005)	$ 1,732
Inventories	**(39,407)**	(80,951)	17,410
Prepaid expenses, taxes and other current assets	**(125,096)**	17,844	(43,433)
Accounts payable	**134,542**	130,489	(74,766)
Other current liabilities	**24,910**	106,958	39,531
Federal and foreign income taxes payable	**5,397**	58,898	34,662
Other accrued taxes	**(7,754)**	(1,633)	15,860
	$ (68,694)	$ 186,600	$ (9,004)

See accompanying notes

Management's Review—Changes in Financial Condition

As reflected in PepsiCo's Statement of Changes in Financial Condition, the internal generation of funds from operations continues to be a significant financial strength of PepsiCo On a cumulative basis, cash provided by continuing operations has been sufficient to fund record capital expenditures and dividends for the past three years

Cash Generated by Continuing Operations vs. Purchases of P.P.&E. and Dividends Paid ($ In Millions)



Continuing operations are PepsiCo's principal source of cash, averaging almost $900 million a year for the last two years Cash from operations is income adjusted for changes in non-cash working capital and items that affect accounting income for a given year, but do not produce cash receipts or payments in the same year, for example, depreciation, deferred income taxes and the refranchising (credit) charge

Cash generated by continuing operations totaled $804 million in 1985, an 18 percent decrease from 1984 The decrease reflected the $145 million increase in **Income from continuing operations**, which was more than offset by a $77 million decrease associated with the **Refranchising (credit) charge** and a $255 million decrease in the amount of cash generated from **Operating working capital** The significant decrease in cash generated from operating working capital from continuing operations was attributable to a smaller increase in other current liabilities in 1985 than was experienced in 1984 coupled with the changes in federal and foreign income taxes payable and prepaid taxes In 1984 cash generated by continuing operations increased 46 percent from 1983, reflecting increases in non-cash charges and a reduction in operating working capital

Investment activities represent the investment and generation of cash from the purchase or sale, respectively, of capital assets and business units

PepsiCo's principal investment activity over the past three years has been the **Purchase of property, plant and equipment** in support of its continuing businesses These investments form the cornerstone of PepsiCo's strategy to invest in its businesses to provide for consistent earnings growth in the future Total spending in 1985 of $786 million was led again by the restaurants segment, reflecting continued additions of company-owned stores and the upgrading of existing stores

Also, 1985 investment activities reflect the cash effects of PepsiCo's strategic restructuring actions begun in 1984 The divestitures of both the transportation segment and Wilson Sporting Goods were completed and the **Receivable from the sale of North American Van Lines** was collected in early 1986

Finally, PepsiCo acquired the **Allegheny Pepsi-Cola Bottling Company** for the purpose of refranchising it to other Pepsi-Cola bottlers to strengthen its bottler system

Financing activities represent PepsiCo's management of its capital structure to achieve a balance between debt and equity that is appropriate in terms of its cash flow and business requirements When external financing is required, and within the constraints of maintaining a strong credit rating, it is generally PepsiCo's policy to use debt rather than equity due to the favorable impact on the overall cost of capital.

PepsiCo's capital structure was significantly affected by financing activities in 1985 as compared to the previous two years During 1985 PepsiCo's Board of Directors approved programs to repurchase up to 9 7 million shares of PepsiCo Capital Stock Through December 28, 1985, 7 3 million shares of PepsiCo's **Capital Stock** were repurchased at an aggregate cost of $458 million When completed, PepsiCo will have repurchased approximately 10 percent of total outstanding shares In evaluating share repurchase, PepsiCo compares economic returns, the impact on corporate performance and after-tax benefits to shareholders with the alternatives of higher dividends or other investment opportunities

The share repurchase programs and the acquisition of the Allegheny Pepsi-Cola Bottling Company gave rise to financing needs that were satisfied principally by the issuance of $603 million of commercial paper The use of short-term instruments to satisfy these requirements was supported by the very attractive short-term rates prevailing for most of the year The commercial paper issued has been classified as **Long-term debt** because it is PepsiCo's intent to refinance these borrowings on a long-term basis during 1986

At December 28, 1985 and February 28, 1986, PepsiCo had unused credit facilities aggregating $1.52 billion, providing it with domestic and international credit availability and support for the issuance and long-term classification of commercial paper, $603 million, which is currently outstanding The existing credit facilities, PepsiCo's portfolio of short-term investments (net of any taxes that may arise as a result of repatriation) and its existing, unused debt capacity provide it with the capital resources to finance the approximately $970 million of commitments associated with the pending acquisitions of MEI Corporation and the franchise beverage business of The Seven-Up Company

Over the past three years, PepsiCo has generated an average of over $100 million of cash from the deferral of income taxes relating to its investment in **Tax leases** PepsiCo's $429 million investment in tax leases in 1981 and 1982 has generated cash benefits of $709 million on a cumulative basis, $362 million of which represents temporary cash savings These cash savings will begin to reverse in 1986, and will require cash outlays, based on the current federal tax rate, of $1 million in 1986, $15 million in 1987, $18 million in 1988, $22 million in 1989, $26 million in 1990 and $280 million in the years 1991 through 2005

PepsiCo paid **Cash dividends** of $161 million in 1985, while retaining sufficient resources and financial flexibility to provide for future earnings growth.

PepsiCo has consistently demonstrated its ability to maintain a strong financial condition, to invest for its future through internal expansion and external acquisition, and provide an attractive return to its shareholders

Consolidated Statement of Shareholders' Equity

(in thousands except per share amounts)
PepsiCo, Inc and Subsidiaries
Years ended December 28, 1985 (fifty-two weeks), December 29, 1984 (fifty two weeks) and December 31, 1983 (fifty-three weeks)

	Capital Stock				Capital in Excess of Par Value	Retained Earnings	Cumulative Translation Adjustment	Total
	Issued		Repurchased					
	Shares	Amount	Shares	Amount				
Shareholders' Equity, December 25, 1982	94,916	$4,746	(1,542)	$ (40,219)	$242,154	$1,489,797	$(46,013)	$1,650,465
1983 Net income						284,111		284,111
Cash dividends declared (per share–$1 62)						(151,358)		(151,358)
Shares reissued to TRASOP			116	3,024	886			3,910
Payment of compensation awards and exercise of stock options....	53	2			1,640			1,642
Conversion of debentures... ...	17	1			350			351
Translation adjustments (net of income taxes of $25,900) ...							5,037	5,037
Shareholders' Equity, December 31, 1983	94,986	4,749	(1,426)	(37,195)	245,030	1,622,550	(40,976)	1,794,158
1984 Net income						212,547		212,547
Cash dividends declared (per share–$1 665) .						(156,185)		(156,185)
Shares reissued to PAYSOP .. .			169	4,412	2,484			6,896
Payment of compensation awards and exercise of stock options. ..	170	9			4,237			4,246
Conversion of debentures	8				164			164
Translation adjustments (net of income taxes of $18,700) .							(8,059)	(8 059)
Amount included in refranchising charge (net of income taxes of $44,500) ..							(391)	(391)
Shareholders' Equity, December 29, 1984	95,164	4,758	(1,257)	(32,783)	251,915	1,678,912	(49,426)	1,853,376
1985 Net income .						543,690		543,690
Cash dividends declared (per share–$1 755)						(161,160)		(161,160)
Shares reissued to PAYSOP . .			76	3,946	478			4,424
Payment of compensation awards and exercise of stock options ..	156	8	25	1,316	5,500			6,824
Conversion of debentures	578	29	299	15,615	24,560			40,204
Translation adjustments (net of income taxes of $100) .. .							8,495	8,495
Share repurchases . .			(7,335)	(458,171)				(458,171)
Shareholders' Equity, December 28, 1985	**95,898**	**$4,795**	**(8,192)**	**$(470,077)**	**$282,453**	**$2,061,442**	**$(40,931)**	**$1,837,682**

See accompanying notes

Notes to Consolidated Financial Statements

Summary of Significant Accounting Policies

Principles of Consolidation The consolidated financial statements include the accounts of PepsiCo, Inc and its subsidiaries (all of which are wholly-owned), except for those held as temporary investments, which are accounted for under the cost method. The financial statements and accompanying notes have been reclassified for discontinued operations All significant intercompany accounts and transactions have been eliminated

Short-term Investments Short-term investments are stated at cost, which approximates market, and include time deposits of $269 million and $481 million at year-end 1985 and 1984, respectively, and secured interests in pools of short-term discounted third-party receivables of $203 million in 1985

Inventories Inventories are valued at the lower of cost (computed on the average, first-in, first-out or last-in, first-out method) or net realizable value

Property, Plant and Equipment Property, plant and equipment, including capital leases, are stated at cost Depreciation is calculated principally on a straight-line basis over the estimated useful lives of the respective assets

Goodwill Goodwill represents the excess of cost over identifiable net assets of companies acquired Goodwill is amortized over appropriate periods not exceeding 40 years Amortization was $8 million in 1985, $10 million in 1984 and $8 million in 1983

Marketing Costs Costs of advertising and other marketing and promotional programs are charged to expense during the year, generally in relation to sales, and except for materials in inventory and prepayments, are substantially expensed by the end of the year in which the costs are incurred

Income Taxes Deferred income taxes arise from the deferral of investment tax credits, which are amortized over the estimated useful lives of the related assets, and from timing differences between financial and tax reporting, principally financing transactions, foreign exchange translation and depreciation.

Taxes that would result from dividend distributions by foreign subsidiaries to the U.S parent are provided to the extent dividends are anticipated. All other undistributed earnings of subsidiaries operating outside the United States have been reinvested indefinitely and no provision has been made for additional taxes that might be payable with regard to such earnings in the event of remittance.

Net Income Per Share Net income per share is computed by dividing net income (adjusted for interest expense related to convertible debentures) by the average number of shares and share equivalents outstanding during each year. The conversion of all convertible debentures would not result in a material dilution.

Refranchising Credit (Charge)

In 1984, PepsiCo recorded a $156 million before-tax and $62 million after-tax ($ 65 per share) charge for the refranchising of several company-owned foreign bottling operations (the Refranchising Program) This charge was comprised of a $24 million before-tax and $11 million after-tax charge for estimated losses from operations expected to be incurred during the course of the Refranchising Program and a $132 million before-tax and $51 million after-tax charge for estimated net losses upon disposition of the various operations

Subsequent to the initiation of the Refranchising Program, charges applied to the operating loss reserve totaled $26 million before-tax and $16 million after-tax Net losses actually incurred to December 28, 1985 upon the disposition of operations refranchised totaled $27 million before-tax (net of a cumulative translation adjustment gain of $50 million) and $3 million after tax As of December 28, 1985 all but one of the company-owned foreign bottling operations in the Refranchising Program have been refranchised As a result of more favorable results than originally estimated from the 1985 refranchisings, the reserve has been reduced and a $26 million before-tax and $15 million after-tax ($ 16 per share) credit has been recorded This credit is reflected in the Consolidated Statement of Income under the caption "Refranchising credit (charge) " The balance of the reserve, $72 million, represents the estimated amount required to complete the Refranchising Program and to provide for other obligations and contingencies related to the completed refranchisings

In 1985 refranchisings were completed in Belgium, Brazil, Canada, the Philippines and South Africa In 1984, a refranchising was completed in Mexico

The remaining net assets of the company-owned foreign bottling operations in the Refranchising Program are carried, net of accruals for future operating and disposition related losses, in the Consolidated Statement of Financial Condition under the caption "Other current liabilities " The net liability arising from the Refranchising Program as of December 28, 1985 and December 29, 1984 is detailed below

	1985	1984
	(in thousands)	
Current assets	$14,308	$ 47,318
Current liabilities	21,249	39,696
Net current assets	(6,941)	7,622
Property, plant and equipment	23,919	78,888
Other non-current assets	4,406	11,602
Non-current liabilities	1,974	2,001
Net non-current assets	26,351	88,489
Net assets	19,410	96,111
Less.		
Accrued future operating and disposition related losses	72,300	160,606[a]
Net liability for refranchising	$52,890	$ 64,495

[a] Represents the year-end balance of the approximately $201 million of accruals established at the outset of the Refranchising Program in 1984 The accruals were reduced by approximately $45 million of balance sheet translation gains transferred from the "Cumulative translation adjustment" account, resulting in a $156 million before-tax charge to 1984 earnings

Discontinued Operations

In 1985 PepsiCo sold its Wilson Sporting Goods operation (Wilson) The proceeds from the sale of $134 million consisted of cash and $42 million (face amount) of Wilson 10 percent cumulative preferred stock, valued at $13 million The loss on the sale of $41 million before-tax and $18 million after-tax ($ 19 per share), includes provisions for certain obligations of Wilson assumed by PepsiCo in connection with the sale, and is reflected in the Consolidated Statement of Income under the caption "Gain (loss) from disposals " Of the loss, $12 million before-tax and $9 million after-tax ($ 09 per share) was recorded in the fourth quarter, primarily to reflect the currently estimated fair market value of the Wilson preferred stock The sale proceeds are subject to adjustments arising from the audit of Wilson's balance sheet as of the closing date, which is not yet complete If PepsiCo and the purchaser are unable to agree upon the adjustments related to Wilson's balance sheet, the contract provides that the differences will be settled by an independent accounting firm agreed upon by the parties Management believes any change will not have a material adverse effect on PepsiCo's business or financial condition

PepsiCo has extended Wilson a $10 million line of credit, expiring December 31, 1986 As of February 1986 the line of credit remains unused. PepsiCo is contingently liable as of December 28, 1985 for $14 million of various obligations of Wilson, including $9 million of short-term letters of credit, which decreased to $3 million in February 1986 The letters of credit expire in August 1986

In 1984 PepsiCo adopted a plan to sell its transportation segment, which was comprised of North American Van Lines, Inc (NAVL) and Lee Way Motor Freight, Inc (Lee Way)

The sale of NAVL was completed in 1985 for a $369 million interest-bearing deferred payment due January 2, 1986 On that date, $376 million, including accrued interest, was received The sale resulted in a gain of $194 million before-tax and $139 million after-tax ($1 49 per share), and is reflected in the Consolidated Statement of Income under the caption "Gain (loss) from disposals "

The sale of Lee Way was completed in 1984 and produced a loss of $16 million before-tax and $15 million after-tax ($ 16 per share) This loss is reflected in the Consolidated Statement of Income under the caption "Gain (loss) from disposals " In 1985 PepsiCo made payments and incurred costs under certain guarantees that existed at, or were entered into in connection with, the sale of Lee Way The purchaser of Lee Way merged into Lee Way in 1985, shortly before filing for bankruptcy The merged company is now in liquidation. PepsiCo has filed a claim to recover the amounts paid or payable under the guarantees, but any significant recovery is uncertain As a result, an additional charge of $10 million before-tax and $7 million after-tax ($ 08 per share) was recorded in the fourth quarter of 1985 This loss is reflected in the Consolidated Statement of Income under the caption "Gain (loss) from disposals "

The results of operations of NAVL, Wilson and Lee Way are recorded in the Consolidated Statement of Income under the caption "Income (loss) from discontinued operations" and include results of operations through the dates in 1985 and 1984 on which the sales of the respective operations were recorded in the financial statements Also included under this caption is the $64 million before-tax and $59 million after-tax ($ 62 per share) Wilson restructuring charge recorded in 1984, primarily resulting from the write-off of $54 million (without tax benefit) of Wilson's goodwill The results of NAVL, Wilson and Lee Way are as follows

	1985	1984	1983
	(in thousands)		
Net sales and operating revenues	$422,240	$ 976,888	$996,052
Costs and expenses	404,802	957,546	988,052
Net interest expense	1,113	2,871	1,822
Wilson restructuring charge	–	64,000	–
	405,915	1,024,417	989,874
Income (loss) before income taxes	16,325	(47,529)	6,178
Income tax provision (benefit)	6,716	(61)	359
Income (loss) from discontinued operations	$ 9,609	$ (47,468)	$ 5,819

The net assets of Wilson and NAVL are carried at their historical cost in the Consolidated Statement of Financial Condition under the caption "Net assets held for disposal" at December 29, 1984 as follows (in thousands)

Current assets	$405,688
Current liabilities	217,566
Net current assets	188,122
Property, plant and equipment	145,887
Other non-current assets	52,529
Non-current liabilities	96,945
Net non-current assets	101,471
Net assets held for disposal	$289,593

Acquisitions

In May 1985 PepsiCo purchased the Allegheny Pepsi-Cola Bottling Company (Allegheny) for $160 million in cash Allegheny was acquired with the intent of refranchising the operations to other purchasers Accordingly, the acquisition has been accounted for as a temporary investment under the cost method and is included in the Consolidated Statement of Financial Condition under the caption "Prepaid expenses, taxes and other current assets "

In December 1985 PepsiCo agreed to purchase the soft drink business of MEI Corporation (MEI) for $590 million in cash The transaction is subject to various conditions, including approval by the shareholders of MEI MEI is PepsiCo's third largest independent bottler This acquisition will be accounted for by the purchase method and is expected to be completed in the second quarter of 1986

In January 1986 PepsiCo agreed to purchase the domestic and international franchise beverage businesses of The Seven-Up Company (Seven-Up) from Philip Morris Incorporated (Philip Morris) for $380 million cash The transaction is subject to various governmental approvals Upon transfer of the international business, PepsiCo is obligated to pay the full purchase price, and assume all the risks of ownership, for both the international and domestic Seven-Up businesses, even though governmental approvals for the transfer of the domestic business may not have been received If, after transfer of the international business, sale of the domestic Seven-Up business to PepsiCo is prohibited under the antitrust laws or if PepsiCo so requests, then Philip Morris is obligated to use its best efforts to sell the domestic business on the same terms and conditions as the proposed sale and to remit the net proceeds to PepsiCo Management believes that none of the foregoing alternatives will have a material adverse affect on PepsiCo's business or financial condition This acquisition will be accounted for by the purchase method

Also, in January 1986 PepsiCo agreed to acquire A & M Food Services, Inc (A & M) in exchange for PepsiCo Capital Stock The number of shares of PepsiCo Capital Stock to be received by stockholders of A&M will be between 584,000 and 741,000 The transaction is subject to various conditions, including approval by the shareholders of A & M A & M is Pizza Hut's largest franchisee This acquisition will be accounted for by the purchase method and is expected to be completed in the second quarter of 1986

Share Repurchases

During 1985 PepsiCo announced plans to repurchase up to 9 7 million shares of PepsiCo's Capital Stock These shares are to be used to fund outstanding convertible securities, employee stock plans and for other corporate purposes

As of December 28, 1985 PepsiCo had purchased 7.3 million shares at an aggregate purchase price of $458 million and had commitments to purchase 260,000 shares at an aggregate purchase price of $18 million As of February 4, 1986 PepsiCo had purchased 9 million shares at an aggregate purchase price of $572 million and had commitments to purchase 57,000 shares at an aggregate purchase price of $4 million

Inventories

Inventories at December 28, 1985 and December 29, 1984 are summarized as follows

	1985	1984
	(in thousands)	
Finished goods	$163,311	$140,482
Raw materials, supplies and in-process	223,132	208,323
Total (approximates current cost)	386,443	348,805
Excess of current cost over LIFO cost	(6,347)	(8,116)
	$380,096	$340,689

Inventories valued at cost, computed on the last-in, first-out (LIFO) method comprised 57 percent of inventories at December 28, 1985 and December 29, 1984

Property, Plant and Equipment

Property, plant and equipment at December 28, 1985 and December 29, 1984 are summarized as follows

	1985	1984
	(in thousands)	
Land	$ 250,671	$ 217,811
Buildings	1,015,068	809,513
Machinery and equipment	2,361,762	1,934,954
Capital leases	170,901	172,535
Bottles and cases	25,048	23,785
	3,823,450	3,158,598
Less accumulated depreciation and amortization	1,251,677	1,042,617
	$2,571,773	$2,115,981

Notes Payable and Long-term Debt

Notes payable and long-term debt (less current maturities) at December 28, 1985 and December 29, 1984 are summarized below

	1985	1984
	(in thousands)	
Notes Payable		
10⅛% notes due 1986	$150,000	$ –
8¼% notes due 1985	–	100,000
Current maturities on other long-term debt and capital lease obligations	25,284	17,789
Other notes payable, primarily to foreign banks	168,853	163,007
	$344,137	$280,796

	1985	1984
	(in thousands)	
Long-term Debt (less current maturities)		
Commercial paper (7 97% weighted average interest rate)	$ 603,000	$ –
10⅛% notes due 1986	–	150,000
Zero coupon serial debentures, $850 million face value due 1988-2012 (13 91% semiannual yield to maturity)	89,361	78,014
13% notes, 50 million Australian dollars, due 1990 (After interest rate swap Variable interest based on 90-day Australian Bank Bill rate–19 6% at year-end)	34,456	–
Zero coupon notes, $100 million face value due 1992 (14.42% semiannual yield to maturity)	42,758	37,213
Zero coupon notes, $125 million face value due 1994 (14 08% semiannual yield to maturity)	41,112	35,896
5¼% bearer bonds, 130 million Swiss francs, due 1995 (After exchange agreement $50 million principal at maturity, 10 96% semiannual yield to maturity)	47,773	–
8% convertible subordinated debentures due 1996	40,088	73,184
Other (11 9% weighted average interest rate)	137,023	161,769
	$1,035,571	$536,076

The original issue discounts associated with the zero coupon issues listed above are being amortized over the lives of the issues on a yield-to-maturity basis For tax purposes, the original issue discounts are deductible on a straight-line basis over the lives of the issues, thus reducing the effective costs of these transactions

At the option of the holder, the convertible subordinated debentures are primarily convertible at a rate of approximately 26 shares for each $1,000 of principal At December 28, 1985, 1 1 million shares were reserved for issuance upon conversion of the debentures

During 1985 PepsiCo issued Swiss francs (SFr) 130 million of 5¼ percent Bearer Bonds, due March 1995 Simultaneously with the issuance of the SFr Bonds, PepsiCo entered into a currency exchange agreement The debt issuance and related agreement created a U S dollar liability in the amount of $50 million at maturity with a semiannual yield to maturity of 10 96 percent

Also in 1985 PepsiCo issued Australian dollar 50 million of 13 percent Guaranteed Notes due 1990 Subsequent to the issuance of the notes, PepsiCo entered into an interest rate swap converting the fixed interest rate to a variable interest rate based on the 90-day Australian Bank Bill rate which at year-end 1985 was 19 6 percent

During 1984 PepsiCo issued $104 million Deutsche mark denominated bearer bonds yielding 7¼ percent, due February, 1994 A major portion of the bond proceeds were used to purchase higher yielding notes of the West German Government that produce cash flows sufficient to meet the interest and principal payments of the bearer bonds PepsiCo defeased the bonds by depositing the Deutsche mark denominated government notes in an irrevocable trust established for the sole purpose of servicing the bearer bonds This defeasance resulted in a $2 million ($ 02 per share) gain, after related expenses and taxes The bearer bonds and promissory notes of the West German Government offset each other in the Consolidated Statement of Financial Condition

At December 28, 1985 PepsiCo had unused credit facilities aggregating $1 52 billion, providing it with domestic and international credit availability and support for the issuance of commercial paper Of the total, approximately $17 million represents lines of credit and $1 5 billion represents revolving credit agreements covering maximum potential borrowings maturing January 2, 1991 These unused credit facilities of $1 52 billion provide PepsiCo the ability to refinance short-term borrowings and currently support the classification of $603 million of commercial paper as long-term debt, since it is PepsiCo's intent to refinance this commercial paper during 1986 on a long-term basis

Maturities of long-term debt (excluding capital lease obligations) are as follows 1986-$165 million, 1987-$6 million, 1988-$46 million, 1989-$14 million, and 1990-$43 million The debt agreements to which PepsiCo is a party include various restrictions, none of which is presently significant to PepsiCo

Interest capitalized as an additional cost of property, plant and equipment was $13 million in 1985, $8 million in 1984 and $7 million in 1983

In February 1986 PepsiCo issued Australian dollar 75 million of 14⅛ percent notes due in 1989 Concurrently with the issuance, PepsiCo has committed to enter into a currency exchange agreement The debt issuance and related agreement create a U S dollar liability in the amount of $51 million at maturity with a floating interest rate based upon the AA Federal Reserve Composite Commercial Paper rate

Employee Stock Option and Ownership Plans

The shareholder-approved 1979 Incentive Plan (the Plan) provides long-term incentives to certain key employees through the granting of performance shares, stock options, stock appreciation rights (SARs) and incentive stock units Under the Plan a maximum of 4.6 million shares of PepsiCo Capital Stock may be purchased or paid pursuant to grants by the Compensation Committee of the Board of Directors (the Committee) at prices not less than 100 percent of the fair market value at the date of grant The Committee is composed of outside directors

Performance shares and an equal number of stock options have been awarded to senior management employees Each stock option represents the right to purchase one share of PepsiCo Capital Stock. The Committee sets the period during which an option may be exercised, however, none are exercisable until four years after the option is granted and may not have a term longer than 10 years from date of grant Stock option activity for the years 1983 through 1985 was as follows

	Option Exercise Prices	Shares Under Option
Balance, December 25, 1982	$23 88 to $43 06	978,526
1983		
Granted ...	–	–
Exercised	$28 31	(22,175)
Cancelled or surrendered for SARs	–	(211,259)
Balance, December 31, 1983	$23 88 to $43 06	745,092
1984		
Granted	$37 00	526,590
Exercised. ...	$23.88 and $24 13	(158,082)
Cancelled or surrendered for SARs	–	(237,129)
Balance, December 29, 1984	$23.88 to $43 06	876,471
1985		
Granted	$34 69	1,488
Exercised.... .	$23.88	(101,548)
Cancelled or surrendered for SARs	–	(103,395)
Balance, December 28, 1985	$34.69 to $43.06	673,016

At December 28, 1985 no options for shares were exercisable Also at year-end 1985, 3,245,613 shares were reserved for issuance under the Plan In January 1986, 278,349 options were issued at an exercise price of $69 25 per share

Each performance share is equivalent to one share of PepsiCo Capital Stock Performance shares are not paid unless PepsiCo achieves earnings per share growth targets established by the Committee for the four-year period following the award Upon a determination by the Committee that a performance share has been earned, the holder receives the lesser of the fa r market value of one share of Capital Stock at the date of award or the fair market value of one share of Capital Stock at the end of the award period. The performance share is paid in cash or Capital Stock or a combination thereof as determined by the Committee. During 1982 and 1984, 1,008,224 performance shares were awarded, of which 694,252 and 804,136 shares were outstanding at December 28, 1985 and December 29, 1984, respectively In January 1986, 278,349 performance shares were awarded

Stock appreciation rights (SARs) permit the holder of a stock option to surrender an exercisable option for an amount equal to the appreciation between the option price and the fair market value of Capital Stock on the date the SAR is exercised or expires The amount is paid in cash or Capital Stock or a combination thereof SARs expire on the same dates as the related options In January 1984, 141,352 SARs were granted, and as of December 28, 1985, none was outstanding In January 1986, 85,385 SARs were granted

Incentive stock units (Units) are awarded by the Committee as incentives to middle management employees Each Unit entitles the holder to receive the value of a share of Capital Stock without payment of any amounts to PepsiCo or satisfaction of any performance objectives Each Unit is valued at the fair market value of the Capital Stock at the end of each vesting period. Currently, 30 percent of each award vests at the end of two years, an additional 30 percent vests at the end of four years, and the remainder vests at the end of six years Payment of the Units is made in cash or Capital Stock or a combination thereof as determined by the Committee From 1979 to 1985, 645,497 Units were awarded, of which 233,894 were outstanding at December 28, 1985

The estimated cost of all awards under the Plan is charged to expense over the applicable terms of the awards The cost was $19 million in 1985, $11 million in 1984 and $13 million in 1983

Effective January 1, 1981, PepsiCo established a Tax Reduction Act Stock Ownership Plan (TRASOP) for the benefit of most employees Beginning January 1, 1983, this plan was changed as a result of the Tax Reform Act of 1982, to a Payroll-based Employee Stock Ownership Plan (PAYSOP) Under these plans, PepsiCo may make a tax creditable contribution of either cash or Capital Stock to a trust on behalf of participating employees During 1985 and 1984, PepsiCo contributed 75,540 and 169,147 shares, respectively, to the employee trust

Income Taxes

U S and foreign income (loss) from continuing operations before federal and foreign income taxes were as follows.

	1985	1984	1983
		(in thousands)	
U S	$440,528	$ 503,592	$509,730
Foreign	197,538	90,100	(90,836)
	638,066	593,692	418,894
Refranchising credit (charge)	25,900	(156,000)	–
	$663,966	$ 437,692	$418,894

The provision for federal and foreign income taxes on continuing operations is comprised of the following

	1985	1984	1983
		(in thousands)	
Current			
Federal	$ 82,132	$ 135,609	$ 77,408
Foreign	6,453	13,568	12,294
Deferred (principally federal)			
Current	74,200	(107,800)	(9,300)
Non-current	81,100	121,300	60,200
	$243,885	$ 162,677	$140,602

The provision for state income taxes, which is included in marketing, administrative and other expenses, was $7 million in 1985, $13 million in 1984 and $26 million in 1983

The differences between the effective and statutory federal income tax rate on continuing operations are comprised of the following

	1985	1984	1983
Statutory federal rate	46 0%	46 0%	46 0%
Investment tax credits	(2 9)	(3 8)	(3 5)
Losses on refranchising of foreign bottling operations taxed at an aggregate rate different than the statutory federal rate	(0 2)	(5 1)	(4 0)
Earnings and losses of foreign operations taxed at an aggregate rate different than the statutory federal rate	(5 7)	(1 2)	(6 0)
Other-net	(0.5)	1 3	1 1
Effective rate	36 7%	37 2%	33 6%

The effective tax rate on earnings from discontinued operations was 41 1 percent in 1985, zero percent in 1984 and 5 8 percent in 1983 The difference between the effective and the statutory federal income tax rate for 1985 and 1983 is principally due to the amortization of investment tax credits For 1984 the difference is principally due to the write-off of Wilson goodwill without tax benefit In 1985 the net before-tax gain of $143 million on the disposal of NAVL and Wilson and the additional costs related to the 1984 sale of Lee Way resulted in an income tax expense of $29 million The effective tax rate of 20 percent is due to the lower capital gain tax rate and the effect of permanent differences between the book and tax basis of the Capital Stock sold The $16 million before-tax loss on the disposal of Lee Way in 1984 generated $500,000 of tax benefit due to the difference in the book and tax basis of the Capital Stock sold and the treatment of the sale as a capital loss

The current portion of deferred federal income taxes of $194 million in 1985 and $176 million in 1984 was included in the Consolidated Statement of Financial Condition under the caption "Prepaid expenses, taxes and other current assets "

Federal and foreign income taxes payable consists of the following

	1985	1984
	(in thousands)	
Federal	$ 96,810	$ 92,673
Foreign	26,799	25,063
	$123,609	$117,736

Deferred income tax expense on continuing operations arises from the following items:

	1985	1984	1983
		(in thousands)	
Excess of tax over financial statement expense related to depreciable assets (including capital leases)	$ 40,900	$ 38,400	$31,400
Excess of tax over financial statement expense related to financing transactions	6,100	21,500	22,200
Net financial statement effect related to refranchising	55,000	(51,600)	–
Deferral of investment tax credit benefits	13,700	4,700	3,800
Prefunded employee benefits	31,300	–	–
Other-net	8,300	500	(6,500)
	$155,300	$ 13,500	$50,900

Deferred income taxes payable include

	1985	1984
	(in thousands)	
Deferred taxes–tax leases	$361,500	$247,500
Deferred taxes–other	372,700	305,300
Deferred investment tax credits	79,500	65,800
	$813,700	$618,600

In 1981 and 1982, PepsiCo invested $429 million in tax leases This investment, reduced by realized tax credits and tax savings from accelerated depreciation deductions, is principally included in the Consolidated Statement of Financial Condition under the caption "Long-term Receivables and Other Investments " The balance of the investment at year-end 1985 and 1984 was $74 million and $78 million, respectively As a result of these investments, actual current taxes payable for 1985, 1984 and 1983 were reduced by approximately $114 million, $116 million and $119 million, respectively. Certain of the tax benefits that arise from these investments are temporary and will be repaid in future years over the lives of the leases The benefits of the tax leases are not included in the provision for federal and foreign income taxes in the Consolidated Statement of Income

Unremitted earnings of subsidiaries operating outside the United States that have been, or are intended to be, permanently reinvested, on which taxes have not been provided, aggregated approximately $314 million at December 28, 1985 and $214 million at December 29, 1984 These unremitted earnings are exclusive of amounts that if remitted in the future would result in little or no tax under current tax laws.

In 1985 PepsiCo reached an administrative settlement with the Internal Revenue Service regarding proposed tax deficiencies of $100 million for the years 1973 through 1978. The proposed deficiencies dealt with the reallocation to the U S. parent company of a portion of the income of foreign soft drink concentrate manufacturing subsidiaries operating primarily in Puerto Rico and Ireland under tax incentive grants The settlement was for significantly less than the proposed deficiencies and had no effect on 1985 results of operations

Leases

PepsiCo and its subsidiaries have noncancellable commitments for rental of restaurant facilities, office space, plant and warehouse facilities, transportation equipment and other personal property under both capital and operating leases Certain franchised restaurants are leased and a portion have been subsequently subleased to franchisees Lease commitments on capital and operating leases expire at various dates to 2031 An analysis of leased property under capital leases by major classes at December 28, 1985 and December 29, 1984 is summarized as follows·

	1985	1984
	(in thousands)	
Buildings	$168,060	$168,842
Machinery and equipment	2,841	3,693
	170,901	172,535
Less accumulated amortization	72,885	68,818
	$ 98,016	$103,717

The following is a schedule of future minimum lease commitments and sublease receivables under all noncancellable leases.

	Commitments		Sublease Receivables	
	Capital	Operating	Direct Financing	Operating
	(in thousands)			
1986	$ 25,097	$ 63,053	$ (7,891)	$ (7,601)
1987	24,416	51,433	(7,778)	(7,323)
1988	23,226	41,762	(7,492)	(6,776)
1989	21,310	37,137	(7,176)	(6,386)
1990	20,184	34,473	(6,829)	(5,841)
Later years	126,418	250,269	(61,582)	(48,614)
Total minimum lease commitments (receivables)	$240,651	$478,127	$(98,748)	$(82,541)

The present value of minimum lease payments for capital leases amounts to $137 million after deducting $2 million for estimated executory costs (taxes, maintenance and insurance) and $102 million representing imputed interest The present value of minimum sublease receivables amounts to $42 million after deducting $57 million of unearned interest income Total rental expense for all operating leases for years ended December 28, 1985, December 29, 1984 and December 31, 1983 was $117 million, $110 million and $108 million, respectively Total rental income from all operating subleases for years ended December 26, 1985, December 29, 1984 and December 31, 1983 was $16 million, $15 million and $15 million, respectively

Employee Benefit Plans

PepsiCo and its subsidiaries have several non-contributory pension plans covering substantially all domestic employees (mostly non-union) The total pension expense for all plans was approximately $37 million, $41 million and $36 million in 1985, 1984 and 1983, respectively, which includes amortization of unfunded past service cost over 30 years for certain defined benefit plans In accordance with recommendations received from its actuary, PepsiCo changed actuarial cost methods in 1985 for its pay-related plans from the frozen initial liability cost method to the projected unit credit method Over a period of years, the change is expected to better match pension expense to benefit obligations The effect of this change was to reduce pension expense by approximately $7 million in 1985

A comparison of accumulated plan benefits and plan net assets for PepsiCo's domestic defined benefit plans is presented below

	January 1 1985	1984
	(in thousands)	
Actuarial present value of accumulated plan benefits		
Vested	$303,338	$268,795
Non-vested	87,009	77,285
	$390,347	$346,080
Net assets available for plan benefits	$469,017	$433,360

PepsiCo changed its funding policy in 1985 from making annual contributions equal to amounts accrued for pension expense to making annual contributions equal to the minimum statutory requirement As a result, $15 million of the 1984 accrued pension expense has not been currently funded and PepsiCo does not currently expect to fund $18 million of the 1985 accrued pension expense These amounts are included in the Consolidated Statement of Financial Condition under the caption "Other Liabilities and Deferred Credits "

The rate of return used in determining the actuarial present value of accumulated plan benefits was seven percent for both 1985 and 1984

In December 1985 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No 87, Employers' Accounting for Pensions None of the provisions of this statement are required to be adopted until fiscal years beginning after December 15, 1986, however, PepsiCo estimates that when adopted, they will have a favorable effect on consolidated income from continuing operations The estimated impact may be affected by future events, the outcomes of which are not known at this time

PepsiCo and its subsidiaries provide certain health care and life insurance benefits for retired non-union employees Substantially all of PepsiCo's employees, including employees in certain foreign countries, may become eligible for those benefits if they reach retirement age while still working for PepsiCo The cost of retiree health care benefits is recognized as an expense as claims are incurred PepsiCo recognizes the cost of providing retiree life insurance by expensing the annual insurance premiums for these benefits The domestic expenditures for retired employees under these programs for the years ended December 28, 1985, December 29, 1984 and December 31, 1983 were $4 million, $3 million and $2 million, respectively Foreign expenditures under these programs were insignificant

Contingencies

PepsiCo and its subsidiaries are involved in various litigated matters, but management believes that the resolution of these matters will not have a material effect on PepsiCo's business or financial condition PepsiCo intends to prosecute or defend vigorously, as the case may be, all such matters

At December 28, 1985 PepsiCo and its subsidiaries were contingently liable under direct and indirect guarantees aggregating $51 million

Business Segments

In 1985 PepsiCo's business segments, formerly referred to as beverages, food products and food service, were renamed soft drinks, snack foods and restaurants to more clearly reflect the products and services of each business

The soft drinks segment primarily manufactures and markets Pepsi-Cola and its allied brands The snack foods segment primarily produces salty snacks The restaurants segment primarily includes the operations of Pizza Hut and Taco Bell

Sales between segments were not significant, and no single customer accounted for more than 10 percent of sales Other than North America, no geographic area accounted for more than 10 percent of sales

Soft drinks amounts for 1985 and part of 1984 exclude the results of company-owned foreign bottling operations in the Refranchising Program In addition, the 1985 and 1984 soft drinks operating profits exclude a $26 million credit and a $156 million charge, respectively, related to the Refranchising Program described on page 43

Operating profits exclude net corporate expenses and net interest expense of $221 million, $222 million and $209 million in 1985, 1984 and 1983, respectively

The operating profits of each business segment include the foreign exchange gains and losses generated by their respective foreign operations Operating profits in the soft drinks segment have excluded the net foreign exchange gains related to the local currency borrowings of the company-owned bottling operations in the Refranchising Program since that program was initiated in the second quarter of 1984 Foreign exchange gains included in consolidated operating profits were $32 million, $53 million and $17 million in 1985, 1984 and 1983, respectively Segment operating profits included total research and development expenses of $66 million, $49 million and $40 million in 1985, 1984 and 1983, respectively

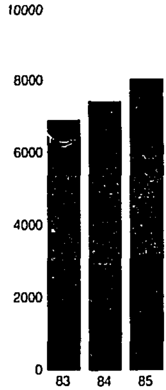
Corporate identifiable assets are principally short-term investments, investment in tax leases, administrative office buildings, the receivable from the sale of North American Van Lines and the investment in the Allegheny Pepsi-Cola Bottling Company

The following summarizes PepsiCo's business segment information

	1985	1984	1983
	(in millions)		
Net Sales:			
Soft drinks	$3,128 5	$2,908 4	$2,940 4
Snack foods	2,847.1	2,709 2	2,430.1
Restaurants	2,081 1	1,833.5	1,529 4
Total continuing operations	$8,056.7	$7,451.1	$6,899 9
Foreign portion	$ 951 9	$ 963 9	$1,128 6
Operating Profits:			
Soft drinks	$ 263 9	$ 246 4	$ 126 2
Snack foods	401.0	393 9	347 7
Restaurants	194.0	175 2	154 3
Total segments	$ 858.9	$ 815 5	$ 628 2
Foreign portion	$ 66 7	$ 35 5	$ (99 1)
Capital Spending			
Soft drinks	$ 160 7	$ 83 6	$ 93 7
Snack foods	286 3	188 9	180 2
Restaurants	331.0	252 5	217 9
Corporate	7.9	30 8	11 6
Total continuing operations	$ 785 9	$ 555 8	$ 503 4
Foreign portion	$ 67.3	$ 36 4	$ 42 4
Identifiable Assets:			
Soft drinks	$1,318 6	$1,038.9	$1,249 0
Snack foods	1,487.1	1,254 5	1,110.1
Restaurants	1,326.7	1,020.7	825 9
Corporate	1,728.8	1,277 0	882 7
Total continuing operations	$5,861.2	$4,591 1	$4,067.7
Foreign portion	$1,054 3	$ 687 5	$ 945 8
Depreciation and Amortization Expense			
Soft drinks	$ 69.2	$ 71.1	$ 84 9
Snack foods	107.7	93 6	81 9
Restaurants	109 2	75 7	58 0
Corporate	4 7	9 2	8 1
Total continuing operations	$ 290 8	$ 249 6	$ 232.9
Foreign portion	$ 25.3	$ 36 8	$ 51.7

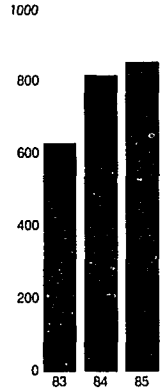
Net Sales by Line of Business

($ In Millions)



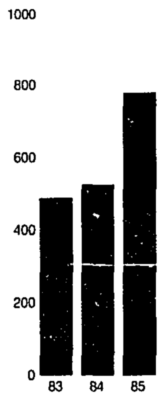
Operating Profits by Line of Business

($ In Millions)



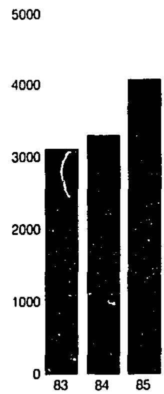
Capital Spending by Line of Business

($ In Millions)



Identifiable Assets by Line of Business

($ In Millions)



Soft Drinks   Snack Foods   Restaurants

Information on the Effects of Inflation (Unaudited)

In accordance with the Statement of Financial Accounting Standards No. 33 as amended, the information presented on this page has been provided under the current cost method in an attempt to measure the impact of inflation on PepsiCo's operations

The current cost method attempts to measure the effects of specific price changes by reflecting the cost to replace existing property, plant and equipment and inventory with identical property, plant and equipment and inventory today The amounts were estimated in a number of ways, including direct pricing and indexing

Also presented is a comparison of the increase in current cost based on specific prices of property, plant and equipment and inventory with the amount of such increase in the general price level. General price level is measured by the movement in the U S Consumer Price Index for all Urban Consumers

PepsiCo's 1985 adjusted financial results reflect a $66 million decrease in income from continuing operations and an increase in net assets of $375 million, which are principally attributable to the cumulative impact of inflation on PepsiCo's property, plant and equipment. The effective tax rate is increased from the historical financial statements because the provision for income taxes is not adjusted for current cost purposes, yet it is compared to reduced pre-tax income

Since PepsiCo had net monetary liabilities during the year, a net gain in purchasing power of $57 million resulted, which should be viewed as part of the overall impact of inflation on operations

The five-year comparison of financial data restated into average 1985 dollars, depicts that sales have grown each year, as have reported sales Income from continuing operations when adjusted for inflation, although always lower than reported earnings, reflects the trends in PepsiCo's reported earnings

Statement of Earnings Adjusted for the Effects of Inflation For the Year Ended December 28, 1985

(dollars in thousands except per share amounts, unaudited)

	As Reported in the Primary Financial Statements (Historical Cost)	Adjusted for Changes in Specific Prices (Current Cost)
Net sales	$8,056,662	$8,056,662
Cost of sales, excluding depreciation	3,080,326	3,082,686
Depreciation and amortization	282,405	346,100
Other operating expenses, net	3,956,869	3,956,869
Net interest expense	98,996	98,996
Refranchising credit	(25,900)	(25,900)
Provision for income taxes	243,885	243,885
	7,636,581	7,702,636
Income from continuing operations	$ 420,081	$ 354,026
Per share	$ 4 51	$ 3 81
Effective income tax rate	37%	41%
Purchasing power gain on net monetary liabilities		$ 57,193
Effect of changes in general price level and specific prices on inventories and property, plant and equipment during the year		
Increase in general price level		$ 58,353
Decrease in specific prices (current costs) [a]		79,968
Excess of increase in general price level over decrease in specific prices		$ 138,321

[a] At December 28, 1985 current cost of inventory was $385,020 compared to $380,096 at historical cost The current cost of property, plant and equipment, net of accumulated depreciation, was $2,961,561 compared to $2,571,773 at historical cost

Five-Year Comparison of Selected Supplementary Financial Data Adjusted for the Effects of Inflation

(dollars in thousands of average 1985 dollars except per share amounts, unaudited)

	1985	1984	1983	1982	1981
Net sales $	8,056,662	7,749,150	7,480,323	7,263,936	7,158,935
Current Cost Information:					
Income from continuing operations $	354,026[a]	209,189[b]	231,519	131,789[c]	223,478
Per share $	3 81[a]	2 22[b]	2 46	1 42[c]	2 44
Excess of increase in general price level over the change in specific prices $	138,321	232,059	128,815	126,814	163,513
Net assets $	2,212,666	2,387,073	2,568,276	2,613,483	2,687,014
Other Information:					
Purchasing power gain on net monetary liabilities $	57,193	51,274	50,676	48,422	108,927
Cash dividends declared per share $	1 755	1 732	1.735	1.768	1 687
Market price per share at year-end $	71 25	42 94	40 78	37 63	41 81
Average consumer price index (1967 = 100)	322 2	311 1	298 4	289 1	272 4

[a] Income from continuing operations in 1985 is net of a $14,900 ($ 16 per share) credit related to an adjustment of the reserve for the refranchising of several company-owned foreign bottling operations

[b] Income from continuing operations in 1984 is net of a $62,000 ($ 65 per share) charge related to the refranchising of several company owned foreign bottling operations

[c] Income from continuing operations in 1982 is net of a $79,400 ($ 83 per share) reduction in the net assets of foreign bottling operations without tax benefit

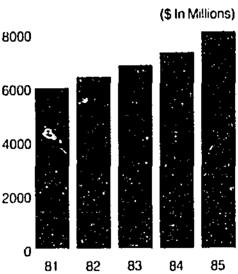
Selected Financial Data

PepsiCo Inc and Subsidiaries
(dollars in thousands except per share amounts unaudited)

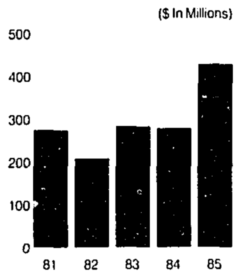
		1985	1984	1983	1982	1981
Summary of Operations						
Net sales		**$ 8,056,662**	7,451,106	6,899,884	6,492,380	6,025,261
Cost of sales and operating expenses		**7,319,600**	6,738,432	6,359,372	5,881,603	5,454,352
Net interest expense		**98,996**	118,982	121,618	114,409	111,893
		7,418,596	6,857,414	6,480,990	5,996,012	5,566,245
Income from continuing operations before unusual credits (charges) and income taxes		**638,066**	593,692	418,894	496,368	459,016
Unusual credits (charges)		**25,900** [a]	(156,000) [b]	–	(79,400) [d]	–
Income from continuing operations before income taxes		**663,966**	437,692	418,894	416,968	459,016
Federal and foreign income taxes		**243,885**	162,677	140,602	213,467	190,146
Income from continuing operations		**$ 420,081**	275,015	278,292	203,501	268,870
Income per share from continuing operations	$	**4.51** [a]	2 90 [b]	2 95	2 18 [d]	2 92
Average shares and equivalents outstanding	#	**93,567**	95,827	95,480	94,904	93,060
Cash dividends declared	$	**161,160**	156,185	151,358	147,127	129,944
Per share	$	**1.755**	1 665	1 620	1 580	1 420
Year-End Position						
Total assets	$	**5,861,160**	4,876,404	4,421,079	4,005,390	3,883,057
Long-term debt [e]	$	**1,162,668**	669,641	799,765	843,901	804,597
Shareholders' equity	$	**1,837,682**	1,853,376	1,794,158	1,650,465	1,556,264
Per share	$	**20.95**	19 74	19 18	17 68	16 99
Shares outstanding	#	**87,706**	93,908	93,561	93,374	91,605
Statistics and Ratios						
Return on average shareholders' equity [f]	%	**22.0**	18 5	16 2	17 6	18 3
Return on revenues [f]	%	**5.0**	4 5	4 0	4 4	4 5
Long-term debt [e] to total capital employed [g]	%	**26.6**	18 7	23 6	28 3	27 0
Total debt to total capital employed [g]	%	**34.5**	26 5	31 7	34 6	40 7
Employees	#	**150,000**	150,000	154,000	133,000	120,000
Shareholders	#	**72,000**	62,000	60,000	48,000	49,000

[a] The unusual credit in 1985 related to an adjustment of the reserve for the refranchising of several company owned foreign bottling operations ($14,900 after-tax or $ 16 per share)
[b] The unusual charge in 1984 related to the refranchising of several company-owned foreign bottling operations ($62,000 after-tax or $ 65 per share)
[c] In 1982 PepsiCo adopted the Statement of Financial Accounting Standards (SFAS) No 52 on foreign currency translation Prior year results have not been restated for SFAS 52
[d] The unusual charge in 1982 related to a reduction in net assets of foreign bottling operations ($ 83 per share) The charge was without tax benefit
[e] Long term debt includes capital lease obligations
[f] The return on average shareholders' equity and return on revenues are calculated using income from continuing operations before unusual credits (charges) and after income taxes
[g] Total capital employed is total debt, shareholders' equity deferred income taxes and other liabilities and deferred credits

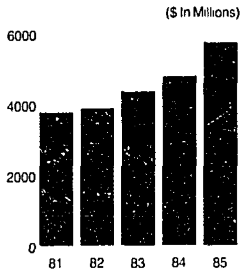
Net Sales



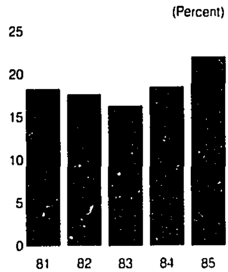
Income From Continuing Operations



Total Assets



Return On Average Shareholders' Equity*



*From continuing operations excluding unusual credits and charges

Quarterly Financial Data and Information on Capital Stock

(in thousands, except per share amounts and stock prices, unaudited)

	First Quarter (12 weeks)		Second Quarter (12 weeks)		Third Quarter (12 weeks)		Fourth Quarter (16 weeks)		Full Year (52 weeks)	
	1985	1984	**1985**	1984	**1985**	1984	**1985**	1984	**1985**	1984
Net Sales	**$1,626,893**	1,552,072	**1,937,512**	1,815,831	**2,071,752**	1,886,894	**2,420,505**	2,196,309	**8,056,662**	7,451,106
Gross profit from continuing operations	**$ 982,589**	931,322	**1,180,554**	1,085,161	**1,267,314**	1,136,534	**1,477,944**	1,323,631	**4,908,401**	4,476,648
Income from continuing operations	**$ 60,529**	47,479	**119,295**	30,334[d]	**135,304**	111,632	**104,953[a]**	85,570	**420,081**	275,015
Income (loss) from discontinued operations	**$ 2,311**	(326)	**136,998[c]**	(72,880)[e]	**—**	6,661	**(15,700)[b]**	4,077	**123,609**	(62,468)
Net income (loss)	**$ 62,840**	47,153	**256,293**	(42,546)	**135,304**	118,293	**89,253**	89,647	**543,690**	212,547
Income (loss) per share										
Continuing operations	**$ .64**	51	**1.25**	32[d]	**1.45**	1 17	**1.17[a]**	90	**4.51**	2 90
Discontinued operations	**$ .02**	(01)	**1.47[c]**	(76)[e]	**—**	07	**(.17)[b]**	05	**1.32**	(65)
Net income (loss) per share	**$ .66**	50	**2.72**	(44)	**1.45**	1 24	**1.00**	95	**5.83**	2 25
Dividends per share[f]	**$ .420**	405	**.445**	420	**.445**	420	**.445**	420	**1.755**	1 665
Market price of Capital Stock[f]										
High	**$ 52¾**	38⅜	**60⅛**	43	**60½**	45	**75⅜**	45⅝	**75⅜**	45⅝
Low	**$ 40⅝**	34½	**50½**	36¼	**55¼**	40½	**57⅜**	39⅞	**40⅝**	34½
Close	**$ 51⅝**	36½	**59**	42⅜	**58⅞**	42⅛	**71¼**	41⅞	**71¼**	41⅞

[a] Income from continuing operations in the fourth quarter of 1985 includes a $14,900 after-tax credit ($ 16 per share) related to an adjustment of the reserve for the refranchising of several company-owned foreign bottling operations

[b] Income (loss) from discontinued operations in the fourth quarter of 1985 includes an additional $8,600 after-tax loss ($ 09 per share) from the sale of Wilson Sporting Goods and a $7,100 after-tax charge ($ 08 per share) from the sale of Lee Way Motor Freight, Inc

[c] Income (loss) from discontinued operations in the second quarter of 1985 includes a $139,000 after-tax gain ($1 49 per share) from the sale of North American Van Lines, Inc and a $9,300 after-tax loss ($ 10 per share) from the sale of Wilson Sporting Goods

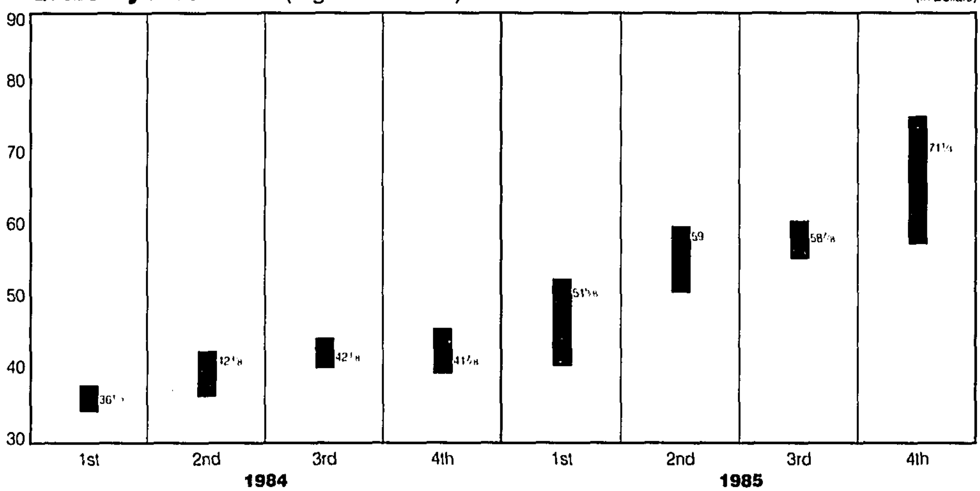
[d] Income from continuing operations in the second quarter of 1984 includes a $62,000 after-tax charge ($ 65 per share) related to the refranchising of several company-owned foreign bottling operations

[e] Income (loss) from discontinued operations in the second quarter of 1984 includes a $59,200 after-tax charge ($ 62 per share) related to the restructuring of Wilson Sporting Goods and a $15,000 after-tax loss ($ 16 per share) from the sale of Lee Way Motor Freight, Inc

[f] The Capital Stock of PepsiCo, Inc is traded on the New York and Midwest Stock Exchanges The quarterly dividend was increased six percent in May 1985 from 42 cents per share to 44½ cents per share In May 1984 the quarterly dividend was increased four percent from 40½ cents per share to 42 cents per share As of February 21, 1986, the approximate number of holders of record of Capital Stock was 71,000

Quarterly Stock Price (High/Low–Close)

(In Dollars)



Shareholder Information

Capital Stock
Shares of PepsiCo Capital Stock are traded on the New York and Midwest Stock Exchanges (Symbol PEP)
On February 21, 1986 there were 85,556,306 outstanding shares of capital stock held by approximately 71,000 shareholders of record The number of shareholders of record includes the many institutions that represent the interests of thousands of beneficial holders

Dividends
PepsiCo's goal is to provide shareholders with the highest return achievable consonant with operating and business goals PepsiCo has consistently paid cash dividends and expects to continue this policy
Cash dividends are declared quarterly PepsiCo's dividend is at an annual rate of $1 78

Dividend Reinvestment Plan
The Dividend Reinvestment Plan for PepsiCo stockholders is being offered by Manufacturers Hanover Trust Company, our transfer agent
Shareholders may direct that all or part of quarterly cash dividends be invested in PepsiCo Capital Stock and may elect to supplement dividend reinvestments with voluntary cash payments PepsiCo pays all brokerage and administrative costs associated with the Plan

Double Dividend Taxation
PepsiCo pays taxes on the earnings that produce shareholder dividends Most of our shareholders also pay taxes on the same dividends If you believe that this double taxation is inequitable, you may wish to write to your congressman

Publications
In addition to the Annual Report, interim reports are mailed to shareholders and include financial results, news of the company and other notices The First Quarter Report includes highlights of the Annual Meeting Shareholders also receive notice of the Annual Meeting, proxy statement and proxy
Many of our divisions publish information booklets about their histories and their products These are available from the divisions on request

Copies of PepsiCo's Form 10-K and 10-Q Reports to the Securities and Exchange Commission may be obtained without charge from the Manager of Shareholder Relations, PepsiCo, Inc., Purchase, New York 10577.

Annual Meeting
The Annual Meeting of Shareholders will be held at the offices of the corporation, Purchase, New York at 10 a m (EDT), Wednesday, May 7, 1986 Proxies for the meeting will be solicited by management in a separate Proxy Statement This report is not part of such a proxy solicitation

Transfer Agent
Manufacturers Hanover Trust Company, 450 West 33rd Street, New York, New York 10001

Shareholder Inquiries
Correspondence concerning your dividend reinvestment account, dividend payments or address changes should be addressed to

Manufacturers Hanover Trust Company
Security Holder Relations, PO Box 24935, Church Street Station, New York, New York 10249, (212)613-7147

Please mention PepsiCo, Inc and include your name, as shown on your stock certificate, address and telephone number in all correspondence
For additional assistance or information please contact

Manager of Shareholder Relations, PepsiCo, Inc , Purchase, New York 10577, (914)253-3055

Financial Information
Security analysts and representatives of financial institutions requiring information are invited to contact

Jerry Hostetter Director, Investor Relations, (914)253-3035

Certified Public Accountants
Arthur Young & Company, 277 Park Avenue, New York, New York 10172

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Printing National Bickford Foremost
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PepsiCo, Inc. Directors and Officers

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President and Chief Operating Officer, PepsiCo, Inc

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Donald M Kendall
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Professor, Harvard Business School

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President, Northwestern University

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Compensation Committee
Messrs Stewart (chairman), Cary, Coleman, Garvin, J Murphy, T Murphy, Strauss and Weber and Mrs Rockefeller

Executive Committee
Messrs Kendall (chairman), Calloway, Cary, Garvin, Pearson and Stewart

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D Wayne Calloway
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General Auditor

Gary M. Stone
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Lawrence F Dickie
Assistant Secretary

Janet M. Lavine
Assistant Treasurer

Claudia E Morf
Assistant Treasurer

Executive Offices

Purchase, New York 10577
(914) 253-2000

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Purchase, New York 10577
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Pepsi-Cola Bottling Group
Purchase, New York 10577
Robert G Dettmer, President

Pepsi-Cola International
Purchase, New York 10577
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PepsiCo Wines and Spirits International
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591 Redwood Highway
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Purchase, New York 10577
Graham G Butler, President


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